NATIONAL TAX JOURNAL

Volume XI, No. 2 June 1958

PUBLISHED QUARTERLY BY THE NATIONAL TAX ASSOCIATION

Fifty-First Annual Conference on Taxation

PHILADELPHIA, PENNSYLVANIA, OCTOBER 27-31, 1958

Headquarters: Sheraton Hotel

NATIONAL TAX JOURNAL

PUBLISHED QUARTERLY BY THE NATIONAL TAX ASSOCIATION

Yearly subscription, $5.00
(To members included in annual dues)
Single copy, $1.50

Publication office:
111 East Chestnut Street
Lancaster, Pennsylvania

Subscriptions and reprint requests should be sent to Walter J. Kress, Executive Director, National Tax Association, 905 Payne-Shoemaker Building, Harrisburg, Pennsylvania. Applications for membership and notice of change of address should be addressed to the Executive Director. Complaints of nonreceipt of publications cannot be satisfied unless filed with the Executive Director within sixty days of publication; thereafter, regular prices will be charged.

Communciations for the editor, manuscripts, and books for review should be sent to Lawrence E. Thompson, Editor, NATIONAL TAX JOURNAL, Soldiers Field, Boston 63, Massachusetts.

Opinions expressed in the JOURNAL are not to be construed as those of the National Tax Association unless expressly so stated.

Entered as second-class matter April 29, 1948, at the post office at Lancaster, Pennsylvania, under the Act of March 3, 1879.

National Tax Journal

Volume XI, No. 2 June 1958

INCOME TAXATION IN THE SOVIET UNION: A COMPARATIVE VIEW *

FRANKLYN D. HOLZMAN †

The purposes of this paper are: (1) to describe the Soviet personal income tax and briefly sketch its history and (2) to compare its provisions (rate structure, dependency provisions, exemptions) with the personal income taxes of the United States and Great Britain.

I

Direct or income taxation of the population in the Soviet Union differs from that in the United States and in many European nations in several basic respects.

Direct taxes on the population in the U.S.S.R. are a relatively minor source of budget revenue. Since 1930, with the exception of the war years when special direct levies were placed upon the population, income taxes have constituted less than 10 per cent of total government receipts. Even during the war years, the proportion never quite reached even 20 per cent. In comparison, the United States personal income tax typically brings in roughly half of the federal government's revenues. The Soviets rely primarily on a turnover tax on consumers' goods for removing excess funds from the hands of the population. Three other items provide as much revenue again as does the income tax: two other price increasing taxes, a tax on the profits of state enterprises and a tax on enterprise payrolls, which is used ostensibly to finance social security payments; and the compulsory sales of government bonds.[1]

* Some of the matters discussed below are treated in this writer's *Soviet Taxation: The Fiscal and Monetary Problems of a Planned Economy*, Cambridge, 1955, 376 pp. Cf. also this writer's "The Soviet Budget, 1928–1952, *National Tax Journal*, Sept., 1953, pp. 226–249; and "Taxes and Standard of Living in the U.S.S.R.: Postwar Developments," *National Tax Journal*, June, 1957, pp. 138–147.

I would like to acknowledge the help and encouragement of Walter W. Brudno, Commonwealth editor of the World Tax Series and Oliver S. Oldman, lecturer in International Tax Law and the Harvard Law School International Program in Taxation of which they are members, and of Professor Harold Berman of the Harvard Law School. I am also grateful to the Harvard Russian Research Center which provided me with office space and facilities and the use of their library during the period of research. Last but not least I am indebted to the Ford Foundation whose fellowship made possible this research. The conclusions, opinions, and other statements in this publication are, of course, my own and not necessarily those of any of the above-mentioned persons or organizations.

An earlier version of this study appeared in the spring of this year in German in *Osteuropa-Recht* (The Hague, Netherlands).

† The author is Associate Professor of Economics at the University of Washington.

1 (See next page)

Soviet reliance on sales taxation is essentially a rational one and is not difficult to understand in light of the historical conditions which existed when the "Five Year Planning for rapid industrialization" era was launched in 1928. The introduction of rapid industrialization meant a sharp increase in taxes. First, from an administrative point of view, the choice between sales and income taxation was a choice between collecting the bulk of state revenue from less than 100,000 state enterprises as opposed to some 30 or 40 million households. This was an extremely important consideration some 25 years ago when many people were illiterate or at least not competent to calculate accurately an income tax and when the peasants had not been completely collectivized and tax-evasion was easy. Second, from an economic point of view, to have levied an income tax which amounted, on the average, to more than 50 per cent of personal income,[2] would have had a disastrous effect on the work-incentives of the population. At this time, the Soviet planners were much concerned over work incentives anyway because of the difficulties which developed as a result of the relative equality of industrial wages. Further equalization due to the introduction of a large progressive income tax would have compounded incentive problems. It was much more sensible for them, at the time, to use sales taxes instead which, because they were largely "hidden"[3] and because they need not be progressive (as income taxes must inevitably be), were much less likely to discourage the incentive to work.

For purposes of direct taxation, the Soviet authorities divide their population into two groups: urban and rural. The urban population pays a tax which is computed not too differently from income taxes levied by other western nations. An entirely different type of tax (called by the Soviets, agricultural tax) is levied on the rural population. This is because the bulk of the income of the average peasant is income in kind. Personal income of the peasant must be assessed in a more complicated manner than that of the industrial wage-earners, and estimation of tax liability must be made on a different basis.

Finally, as we shall see below, the Soviet income taxes are used in a very discriminatory manner, favoring some groups in the population relative to others. Workers and collective farmers pay smaller amounts of tax than, for example, do doctors on income from private practice or peasants not belonging to a collective. This feature of the income taxes was especially important before World War II when the discriminated-against groups were more numerous. Today it has much less applicability. Most Western nations do not, of course, so blatantly differentiate their taxes by social and political categories of taxpayers.

II

The income tax was first introduced in November, 1922 as part of a com-

[1] These were discontinued after 1957. Cf. this writer's "An Estimate of the Tax Element in Soviet Bonds," *American Economic Review*, June, 1957, pp. 390–396; and "The Great Soviet Bond Hoax," *Problems of Communism*, Sept.–Oct., 1957.

[2] During the 'thirties, the average rate of taxation fluctuated from 50 to 60 per cent of personal income. Cf. this writer's *Soviet Taxation: The Fiscal and Monetary Problems of a Planned Economy*, Harvard University Press, 1955, chap. 10.

[3] This was accomplished by levying the tax at an early stage in the production process so that the retailers and consumers are not conscious of and have no way of determining the amount by which the price of commodity is raised by the sales tax.

bined income and property tax.[4] In 1924, the property tax provisions were dropped and the income tax provisions were revamped to introduce, for the first time, the principle of social and political discrimination.[5] Further changes were made in the income tax in 1926, in particular, a separate progressive set of rates was established for each group. The formal structure of the tax law in effect in 1926 is very much the same as the one in effect today though details of rates, classifications, exemptions, etc. have been changed many times.

The income-tax law in force today dates back to an edict (*ukaz*) of the Supreme Soviet of April 30, 1943. The edict has, of course, been amended many times over the past 15 years. The schedule of rates established in 1943 is presented in Table I. The edict provided that all persons not primarily engaged in agricultural pursuits (and subject to the agricultural tax) are subject to an individual income tax. Taxpayers were divided into five social and economic groups: (1) workers and salaried employees, students, and some others; (2) artisans and handicraftsmen belonging to cooperatives; (3) artists of all kinds (writers, musicians, painters, etc.); (4) professionals in private practice (doctors, lawyers, etc.); (5) artisans and handicraftsmen not belonging to cooperatives but working for themselves, members of clergy, and all others considered to be making unearned income. There is a separate rate schedule for each of the above groups, with the exception of the coop artisans whose liability is estimated from the worker and salaried employee schedule but at a 10 per cent higher rate.

Since the end of World War II, a number of changes have been made in the schedules presented in Table I.

1) By an edict of the Supreme Soviet on Sept. 21, 1946, the non-tax minimum for those in category 1 was raised from 1800 to 3120 rubles a year (260 rubles a month).[6]

2) Sometime during the Fourth Five Year Plan (1946–1950), the maximum rate on artists was reduced to 13 per cent on all income over 12,000 rubles annually.

3) By an edict of the Supreme Soviet of January 1, 1951, categories (4) and (5) received minimum exemptions of 600 rubles a year. The rate schedule for (4) was then raised: from 2½ per cent on 600–1800 rubles to 69 per cent on all income over 70,000 rubles. Group (5) had its rates correspondingly increased from 4 per cent at the bottom of the rate schedule to 81 per cent.[7]

It is important to note that many persons in the Soviet Union hold more than one job. In computing tax liability, the total income from various jobs is not added up but rather the taxpayer is taxed at each place of work separately. He is allowed, however, to deduct the basic exemption of 3120 rubles from his basic job only. The reduction for dependents (below) similarly can be taken only with respect to the basic job. The tax on income from other jobs begins at 1½ per cent on income up to 1800 rubles, and thenceforth follows the 1944

[4] Cf. V. P. D'iachenko, *Soviet Finance in the First Phase of Development of the Soviet State*, Moscow, 1947, p. 250 (in Russian).

[5] Cf. *Collected Laws and Regulations of USSR*, 1924 # 20 article 196. (in Russian).

[6] K. N. Plotnikov, *Studies in the History of the Budget of the Soviet State*, Moscow, 1954, p. 395 (in Russian).

[7] Plotnikov, *op cit.*, p. 479; A. M. Aleksandrov, *Finance in USSR*, Moscow, 1952, p. 331 (in Russian).

schedule presented in Table I.[8] Where more than one member of the family works, and this is quite common in the U.S.S.R., each member is taxed separately, and, as we have seen, on each job. Taxes are collected, incidentally, as a deduction from wages at place of work.

Also subject to the income tax are foreigners who work in Soviet enterprises and Soviet citizens who work abroad but are paid by Soviet enterprises or establishments (such as diplomatic personnel). Diplomatic personnel working abroad pay according to the worker and salaried employee scale. Foreign diplomats working in the Soviet Union are not subject to the Soviet income tax.[9]

There are many other full and partial exemptions from the income tax. All persons with more than three dependents receive a 30 per cent reduction in tax rate. (As we shall see below, supplementary measures provide additional advantages for those with dependents.) At one time all soldiers and officials of the Ministry of Armed Forces were exempt from the income tax. In the edict of the Supreme Soviet of January 1, 1951, however, all members of the armed forces, except the lowest categories of enlisted men, were made liable. Some of the types of cash and non-cash income which are exempt from income taxation are: free housing and other

TABLE I

Personal Marginal Income Tax Rates on the Urban Population, 1943
(per cent of yearly income)

Annual Income (rubles)	Workers and Salaried Employees	Artists and Writers	Professionals With Income from Private Practice	Noncooperative Artisans, Shopkeepers, Ecclesiastical Personnel
Under 1,800	0%	1.5%	2.0%	3.0%
1,800– 2,400	5.5	5.5	6.0	8.0
2,400– 3,600	6.0	6.0	8.0	12.0
3,600– 4,800	7.0	7.0	11.0	16.0
4,800– 6,000	8.0	8.0	15.0	20.0
6,000– 8,400	10.0	10.0	19.0	25.0
8,400– 12,000	12.0	12.0	23.0	30.0
12,000– 18,000	13.0	13.0	27.0	35.0
18,000– 24,000	13.0	14.0	32.0	40.0
24,000– 30,000	13.0	15.0	37.0	45.0
30,000– 50,000	13.0	16.0	42.0	50.0
50,000– 70,000	13.0	18.0	47.0	57.0
70,000–100,000	13.0	23.0	55.0	65.0
100,000–150,000	13.0	31.0	55.0	65.0
150,000–200,000	13.0	41.0	55.0	65.0
200,000–300,000	13.0	51.0	55.0	65.0
Over 300,000	13.0	55.0	55.0	65.0

Source: Edict of Supreme Soviet of April 30, 1943.

Note: See text for changes made in above rates since 1946. The most important of these changes have been: raising workers' exemptions to 3120 rubles; setting a maximum rate of 13 per cent on artists' income, and raising the rates on the last 2 categories of payers. It should be stressed that probably 98 per cent of those subject to the income tax fall in the category: workers and salaried employees.

[8] M. A. Gurvich, *Soviet Financial Law* (Moscow, 1955), p. 216 (in Russian); S. Vinokur and A. Mogilevich, *Calculation and Collection of Taxes from Wages of Workers and Salaried Employees*, Moscow, 1956, pp. 15–16 (in Russian).

[9] Gurvich, p. 217.

services provided to doctors, veterinarians, teachers, and other professionals in rural localities; payments to employees to help amortize the cost of special equipment where such equipment is essential to the job; Stalin prizes; interest on state bonds and lottery winnings; receipts from the sale of personal property; personal and property insurance; subsidies to mothers; inheritance and gift money.[10] In addition, persons who are willing to migrate to the northern regions are freed from tax on all income from hunting, fishing, and handiwork; workers are allowed small gardens tax free; prospectors for gold and other rare metals are exempt from taxation in connection with this work; inventors are allowed 10,000 rubles of tax-free income from each invention; and persons who engage in other special work which the state encourages (e.g. raising bees) are allowed special deductions.

In connection with the administration of the tax, insufficient tax payment in any month must be made good within the next 3 months. Surplus payments, on the other hand, are returned only once a year. Persons who do not have a regular place of work from which their tax may be deducted must declare their income and make payment by January 15th or be subject to a 200 ruble fine. Delays in payment of tax or fine are subject to a penalty fine of .2 per cent per day.[11]

III

As we have already noted, persons with four or more dependents receive a 30 per cent deduction from the income tax. Persons with children benefit relative to others in two other ways which are, in effect, supplementary to the 30 per cent tax deduction.

In November, 1941, " a tax on bachelors, single persons, and persons with small families " was introduced. It received its present form on July 8, 1944.[12] The tax is levied on all males between 20 and 50 years of age and on all females between 20 and 45 years of age. The tax schedule is quite simple: all persons with non-agricultural income pay 6 per cent of their income if they have no children, 1 per cent of their income if they have one child, and ½ per cent if they have two children.[13] Before 1953, the tax also applied to the rural population and required payments of 150, 50 and 25 rubles, respectively, of persons with none, one, or two children. Since then, however, the payment has been combined with the regular agricultural tax.[14]

In 1936, the Soviets initiated a program of non-taxable subsidies to mothers with three or more children. While there is no legal connection between the subsidies and the income tax, the subsidy does, in effect, strengthen the dependency provisions of the income tax law.[15] The present schedule, which has been in effect since 1948, was established by an edict of the Supreme Soviet dated November 27, 1947. It provides that upon the birth of a child, each

10 There is no inheritance tax, but a 10 per cent legal fee must be paid upon distribution of the estate.

11 Gurvich, p. 217.

12 G. L. Mar'iakhin, *Taxes and Collections from the Population and Collective Farms*, Moscow, 1946, pp. 77–80 (in Russian).

13 At its meeting in December, 1957, the Supreme Soviet revoked the bachelor's tax on all persons with children. The tax now applies only to single persons and childless couples.

14 Plotnikov, p. 479.

15 For the method by which Canada integrates its non-taxable family allowances (" baby bonus ") into the income tax dependency deduction see *Taxation in Canada*, by J. Harvey Perry, Univ. of Toronto Press (Canadian Tax Foundation), 1951, p. 56.

mother receives: (1) a lump-sum payment which varies from 200 rubles for the third child to 2,500 rubles for the eleventh, and (2) a monthly stipend beginning with 40 rubles for the fourth child to 150 rubles for the eleventh. This form of dependency provision was probably necessary in the U.S.S.R. for the simple reason that the income tax is relatively such a small part of the tax burden that dependency provisions attached to it are inevitably inadequate to provide for the differential needs of those with children. The subsidy viewed as a dependency provision is much better tailored to the needs of lower-income groups than exemptions tied to the income tax; they are, on the whole, much less regressive. Under most income tax laws all persons exempt from paying taxes, either because they have too low a basic income or because they have too many dependents, are treated alike regardless of how far below the taxable level their income is or how many dependents they have in excess of the requirement for exemption.

The relative importance of the 30 per cent income tax exemption for dependents, the tax on bachelors, etc., and the subsidy to mothers is demonstrated in the hypothetical schedules estimated for Table II. The income tax exemption is the least significant of all, while the subsidies to mothers is most important. The dependency relief increases steadily as the number of children increases, and the low income household receives greater dependency relief than the average income household.

TABLE II
Soviet Dependency Relief
(per cent of income)

Number of Dependents	Average-Income Household, 1950 (annual income 12,000 rubles) [a]					Low-Income Household (annual income 6,000 rubles)
	Subsidy to Mothers		Tax on Bachelors, etc.	Income Tax	Total	
	Lump Sum [b]	Monthly				
0	0 %	0 %	0 %	0 %	0 %	0 %
1	0	0	5.0	0	5.0	5.0
2	0	0	5.5	0	5.5	5.5
3	0.2	0	6.0	0	6.2	6.4
4	0.5	4.0	6.0	2.5	13.0	16.6
5	0.7	6.0	6.0	2.5	15.2	21.0
6	0.8	7.0	6.0	2.5	16.3	23.2
7	1.0	10.0	6.0	2.5	19.5	29.6
8	1.0	10.0	6.0	2.5	19.5	29.6
9	1.5	12.5	6.0	2.5	22.5	35.6
10	1.5	12.5	6.0	2.5	22.5	35.6
11	2.1	15.0	6.0	2.5	25.6	41.8

Source: *Soviet Taxation*, p. 182.
[a] Based on an average wage of 8,000 rubles, with 1.5 persons per family employed.
[b] For purposes of this table, the lump-sum payment is assumed to be paid over a 10-year period in ten equal annual payments.

IV

The peasant population is subject to two major forms of income taxation as well as a number of minor taxes. We shall be concerned here with the tax in money levied on the peasant. He is also subject, however, to a tax in kind.

This consists of having to deliver to the state, at nominal prices which are considerably below cost of production, a part of his crop or of his animals. These deliveries do not appear directly in the budget, and we have no way of measuring their relative significance in comparison with peasant income.[16] There is some reason to believe, however, that they constitute a larger levy on the peasant than the money tax described below. Before 1923, the tax on the peasant was entirely " in kind." Monetary taxes were first introduced in 1923 and 1924.[17]

The basic unit of taxation under the agricultural tax is the family rather than the individual, as under the income tax. This is due to the difference in conditions of employment between urban and rural areas: in the latter, members of a family are more likely to work together as a unit. This is particularly true of their work on their private plots of land. For purposes of the agricultural tax, persons are divided into two major categories: 1) those who work on the collective farms (the collective farmers) as well as on their private plots, and 2) those who work exclusively on their private plots. Needless to say, very few farmers fall in the latter category anymore. Each household is taxed on the income from cultivating its personal plot of land and from owning animals. The collective farmers are favored by law in two respects: first, they do not have to pay any tax on the income they earn working for the collective farm; second, the private farmer must pay a 100 per cent higher tax than the collective farmer on all income earned. In general, exemptions are similar to those for the income tax.

In recent years two quite different techniques of estimating tax liability have been employed. An edict of the Supreme Soviet of September, 1939 established the law which was in effect until 1952. Under this edict, no attempt was made *actually* to ascertain the income of the peasants. Instead, each of the peasant's income-earning activities (e.g. sowing a hectare of wheat, raising a pig, etc.) was valued according to norms. The norms differed according to republic and region. Total income was then estimated by adding up

TABLE III

NORMS OF INCOME FOR THE RUSSIAN FEDERATED REPUBLIC, 1952
(rubles)

Income per 0.01 Hectare Sown or Planted		Income per Head of Livestock	
Grain	45	Cows	2,540
Potatoes	64	Sheep and goats	180
Vegetables, etc.	140	Pigs	800
Orchards	160	Horses and mules	2,500
Vineyards	180	Oxen	1,500
Hay	8		

Source: *Soviet Taxation,* p. 188.

the income from individual activities as valued by the norms. Norms were varied by republic and region depending on fertility, etc., and republic and regional authorities were given the power to vary their norms by 30 per cent to allow for local differences. A sample of the norms in effect for the Russian Federated Republic in 1952 is presented in Table III. Once taxable income had been estimated by the use of norms, the tax liability of the farmers was estimated by applying the rates presented in Table IV. As already mentioned, farmers working exclusively on

[16] Cf. this writer's *Soviet Taxation*, Cambridge, 1955, chapter 7 for a description of the tax in kind and an attempt to quantify its importance.

[17] *Collected Laws and Regulations*, USSR: 1923 # 42 article 451, 1924 # 58 article 570.

their private plots paid (and still pay) double rates. Households whose able-bodied members did not all work on the collective farms paid at 75 per cent (50 per cent before 1952) higher rates than those shown in Table IV.

The present form of agricultural tax was put into effect on July 1, 1953.[18] Tax liability is now estimated directly from the amount of cultivable land in use by the farmer regardless of how the land is used or of the extent of livestock holdings. Thus tax liability is now estimated much more simply, the intermediate step of first computing income having been eliminated. Rates are differentiated as before, however, by republic, region, for availability of irrigation, etc. The rates are presented in Table V.

TABLE IV

Agricultural Tax Rates, 1952

Estimated Annual Income (rubles)	Amount of Tax
Under 2,000	12 per cent
2,000–3,000	240 rubles + 14 per cent on income over 2,000 rubles
3,000–4,000	380 rubles + 18 per cent on income over 3,000 rubles
4,000–5,000	560 rubles + 26 per cent on income over 4,000 rubles
5,000–6,000	820 rubles + 33 per cent on income over 5,000 rubles
6,000–7,000	1,150 rubles + 40 per cent on income over 6,000 rubles
Over 8,000	1,950 rubles + 48 per cent on income over 8,000 rubles

Source: *Soviet Taxation,* p. 188.

The major significance of the change in the structure of the agricultural tax seems to be that the earlier tax was progressive while the present tax appears to be roughly proportional in its impact on different income groups. The progressivity of the 1939–52 agricultural tax undoubtedly had a disincentive effect on the peasants with regard to work on their private plots. The agricultural crisis in the early 1950's and subsequent encouragement by the regime of the peasants' private profit motive undoubtedly explain the change in form of taxation. In this same vein, it should be noted that the new law places no tax on animal husbandry, the area of agriculture which lagged most seriously. Probably for incentive reasons also, the total amount of tax to be (and actually) collected under the new law is much less than under the old law. Finally, the greater simplicity of the new levy was expected

TABLE V

Rates of Agricultural Tax, by Republic
(in rubles per .01 hectare)

Republic	Rates		
	Average	Lowest	Highest
Russian Federal ...	8½	3	14
Ukraine			
Eastern region ...	8½	5	12
Western region ..	4	2	6
White Russia			
Eastern region ...	6	3	9
Western region ..	3	2	5
Uzbek			
Irrigated land ...	22	..	..
Non-irrigated land	8	..	..
Kazakh	8	4	13
Georgia	13	4	25
Azerbaijan	12	6	18
Lithuania	3	..	..
Moldavia			
Left-bank region .	8	..	..
Right-bank region	4	..	..
Latvia	4	..	..
Kirghiz	9	4	13
Tadzhik			
Irrigated land ...	22	..	..
Non-irrigated land	8	..	..
Armenia	13	..	..
Turkestan			
Irrigated land ...	20	..	..
Non-irrigated land	8	..	..
Estonia	4	..	..
Karelo-Finnish	5	..	..

Plotnikov, p. 483.

[18] *Pravda,* August 10, 1953. The decree is dated August 8, 1953.

to reduce the costs of administering the tax.

V

An attempt will be made in this section to compare crudely the progressivity of Soviet, British and American income taxes.[19] Comparisons of this sort are fraught with difficulties and pitfalls because of the substantial differences between the income tax structures and concepts of taxable income of different nations, the differing importance of the income tax in the fiscal structures of nations, differences in per capita output and consumption, and so forth. An outstanding drawback of the comparison to be presented below is the fact that the Soviet income tax plays a very small role in the Soviet tax structure, as noted in section I, whereas the United States and British income taxes are major fiscal weapons of these two nations.

The marginal tax rate schedules are presented in Table VI. In the Soviet case, only two of the four schedules are presented: those for workers and salaried employees and for professionals with private practices. It should be noted that the latter category is a very small one. For ease of comparison, the material in Table VI is presented graphically in Charts I and II. For purposes of comparison, the income scales for the three countries are aligned so that the tax rates can be compared for families or individuals occupying similar positions in the income strata of the respective countries. Average income for the different countries was based very roughly on average wage. This led to crude benchmarks in 1956 of 9,000 rubles, $4500, and £500 for the Soviet Union, United States and Great Britain, respectively. It seems highly probable that more people have relatively high incomes, particularly in the United States, than is true of the Soviet Union.

[19] For a good discussion of problems and methods in this area cf.: R. A. Musgrave and T. Thin "Income Tax Progression, 1929–1948", *Journ. of Pol. Econ.*, Dec., 1948, pp. 498–514.

From Charts I and II, the following deductions emerge:

1) The taxpayer with less than average income pays according to a much higher gross schedule in Great Britain and the United States than in the U.S.S.R.

2) The Soviet worker and salaried employee pays the least amount of tax throughout the entire income range. The maximum rate of 13 per cent is reached at income levels only slightly above the average income line. It should be noted that the number of salaried employees (e.g. factory managers, outstanding academicians) who make 10 or 15 times as much as the average is not insignificant.

3) The Soviet professional in private practice is not quite as well off as an American using a joint return (see below) in the medium-upper income brackets; this relationship is reversed at the highest income levels.

Some of our deductions are not realistic if different methods of tax computation between nations are taken into account and if basic dependency exemptions are allowed for. Both the American and Soviet rate schedules are less severe than the British, particularly in the higher income brackets, in situations in which there is more than one gainfully employed person in a family. In the British case, technically the incomes of both husband and wife are added together and taxed according to the same rate schedule. This means that if the

husband and wife both earn or receive income, they are taxed jointly as if the income had all been earned by the husband with the exception that 7/9 of the wife's first £180 of earned income is exempted. In the Soviet Union, as we have seen, each person would be taxed individually and therefore at the lower rates applicable to the separate incomes.

In the United States, husband and

TABLE VI

Comparative Marginal Tax Rate Structures: United Kingdom, United States and Union of Soviet Socialist Republics, 1956

Union of Soviet Socialist Republics			United States				United Kingdom	
	Tax Rate		Single Person		Married Person (Joint Return)			
Income (1,000 rubles [1])	Workers and Salaried Employees	Professionals [b]	Income ($1,000)	Tax Rate	Income ($1,000)	Tax Rate	Income (£1,000 [2])	Tax Rate
0 - 1.8	0 %	2.0%	0– 2	20%	0– 4	20%	0 - .060	11.25%
1.8– 2.4	0	6.0	2– 4	22	4– 8	22	.060– .210	23.75
2.4– 3.6	6.0[a]	8.0	4– 6	26	8– 12	26	.210– .360	33.75
3.6– 4.8	7.0	11.0	6– 8	30	12– 16	30	.360– 2.0	42.5
4.8– 6.0	8.0	15.0	8– 10	34	16– 20	34	2.0 - 2.5	52.5
6.0– 8.4	10.0	19.0	10– 12	38	20– 24	38	2.5 - 3.0	55.0
8.4–12.0	12.0	23.0	12– 14	43	24– 28	43	3.0 - 4.0	60.0
12.0–18.0	13.0	27.0	14– 16	47	28– 32	47	4.0 - 5.0	65.0
18.0–24.0	13.0	32.0	16– 18	50	32– 36	50	5.0 - 6.0	70.0
24.0–30.0	13.0	37.0	18– 20	53	36– 40	53	6.0 - 8.0	75.0
30.0–50.0	13.0	42.0	20– 22	56	40– 44	56	8.0 -10.0	80.0
50.0–70.0	13.0	47.0	22– 26	59	44– 52	59	10.0 -12.0	85.0
70.0–	13.0	55.0	26– 32	62	52– 64	62	12.0 -15.0	90.0
			32– 38	65	64– 76	65	15.0 -	92.5
			38– 44	69	76– 88	69		
			44– 50	72	88–100	72		
			50– 60	75	100–120	75		
			60– 70	78	120–140	78		
			70– 80	81	140–160	81		
			80– 90	84	160–180	84		
			90–100	87	180–200	87		
			100–150	89	200–300	89		
			150–200	90	300–400	90		
			200–	91	400–	91		

[a] In 1946, the non-tax minimum was raised to 3,120 rubles with 3,120–3,600 rubles subject to 6 per cent levy.

[b] As mentioned in the text, in 1951 a 600 ruble exemption was granted and the whole schedule for professionals was raised. Since only a few figures from the new schedule have been published, the older one is used here.

Sources:

U.S.S.R.: see text.

U.S.: Internal Revenue Service, "Your Federal Income Tax."

U.K.: Taxation, *World Tax Series: Taxation in the United Kingdom* (Harvard Law School International Program in Taxation), pp. 365, 368–374, prepared by Walter W. Brudno and Frank Bower (Boston, Little Brown & Co., 1957).

[1] The ruble is valued officially at four to the dollar. This is probably a reasonable rate for producers' goods which are generally low-priced in the U.S.S.R. A more appropriate rate for consumers' goods would be in the neighborhood of ten rubles to the dollar. This is, in fact, the special rate granted to tourists in the Soviet Union.

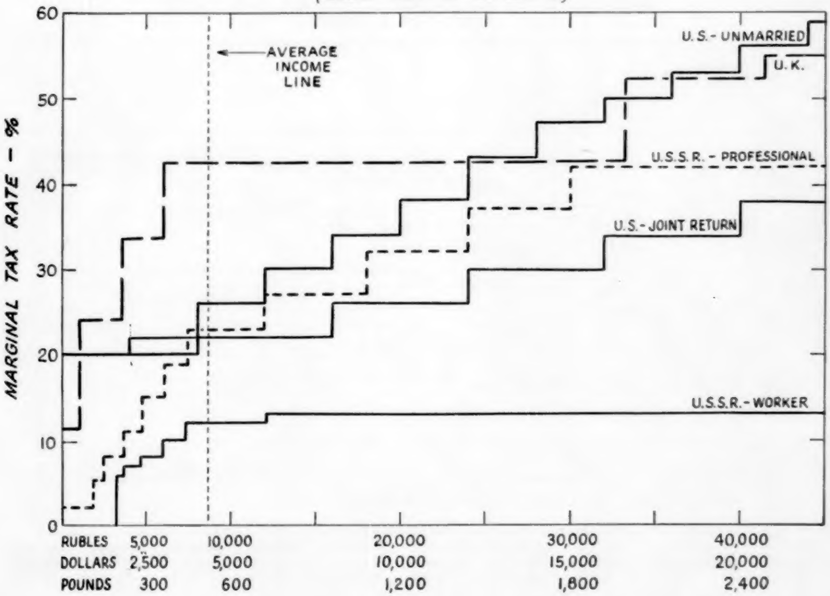
[2] The official exchange rate for the pound is $2.80.

wife can also be taxed separately on their separate incomes. However, under the method usually used, income-splitting, they file a joint return which assures that the maximum applicable marginal tax rate will not be greater than that which would apply on only one-half of their total income. This has the effect of attributing to each of the spouses half of their total income and then permitting them to file separately. The advantages of income-splitting in the United States are available even if the wife has no income at all. Finally, in the case of the United States, it should be mentioned that in lieu of other personal expenses deductions, there is allowed a standard 10 per cent deduction which cannot exceed $1000 in amount.

CHART I

Comparative Tax Structures in 1956: U.S., U.K., U.S.S.R.

(Lower Part of Schedules)

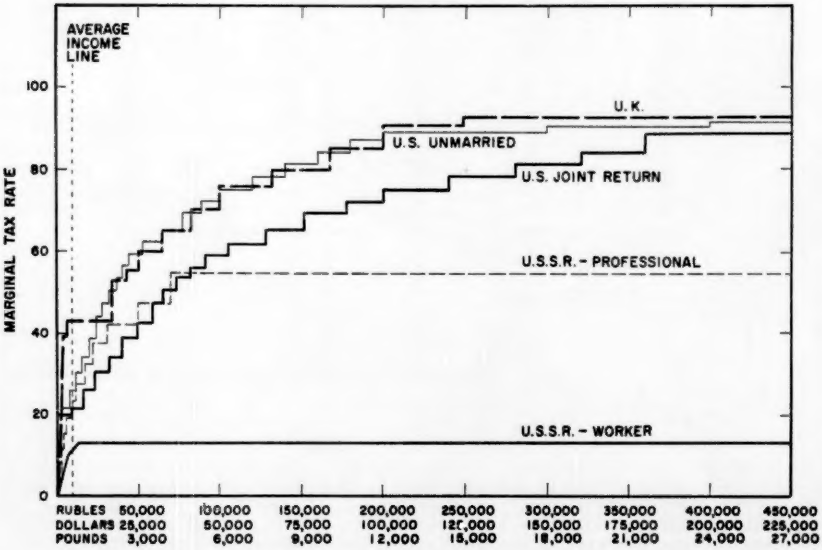


The British disadvantage just mentioned above is more than offset in the lower income brackets by special exemptions. First, a married person is allowed an exemption of £240 plus £85 for each dependent child. Second, the husband is entitled to an "earned income allowance" of 2/9 of earned income which allowance is not to exceed £450. Third, there is the wife's "earned income allowance" mentioned in the preceding paragraph. Thus, families with two children are likely to have exemptions roughly equal to the income of the average British household. However, in view of the steeply progressive rate structure of the the British income tax, these exemptions have little effect on tax liability in the higher income brackets. The dependency exemption

in the United States is $600 a person including parents or roughly half of average income for a family with two children. In the Soviet Union, two children would not entitle a family to any exemptions; in fact, the family until this year was liable to a special one-half per cent extra levy under the tax on bachelors and small families. Furthermore, the family is too small to receive a subsidy for having children.

Union; also contrary to (1) above, the British pay at a lower rate than Americans. It would seem that a four person family with average income in Great Britain probably pays no income tax. It would also seem that for the bulk of the taxpayers (all families with say, less than 1½ average income), the British family pays at a lower rate of income tax than even the Soviet worker and salaried employee.

CHART II
COMPARATIVE TAX STRUCTURES IN 1956: U.S., U.K., U.S.S.R.
(Upper Part of Schedules)



The effect of these factors is demonstrated crudely in Table VII and Chart III where the tax liabilities of families with two children are computed for the three countries for a few benchmark incomes. The following deductions seem warranted:

1) Contrary to our first deduction above, families with less than average income in Great Britain and the United States pay at a lower rate of income tax than their contemporaries in the Soviet

2) The British tax is, however, steeply progressive and quite rapidly overtakes the others. High income families in Great Britain (10 times average income) pay a higher rate of tax than families in either of the other two countries.

In conclusion it is worth noting that if one is concerned with the " burden " of a tax, it is relevant to consider not only the per cent of personal income taken by taxation in each country, but also the absolute level of a person's in-

come in each country. To illustrate this, suppose that the tax liability for an average-income family is precisely the same in two countries. Suppose also that the standard of living of the average-income family is twice as high in one country as in the other. It would probably be fair to say that the tax " burden " on an average-income family in the lower income country is greater than in the higher income country.

Now the standard of living in the Soviet Union is much lower than that in either the United States or Great Britain, and that in Great Britain is considerably lower than in the United States. Let us assume, again for purposes of illustration, that the ratios are 4:2:1—which may not be too far from the correct order of magnitudes. In this case, the " burden " of tax is seen to be much greater at lower income levels on a Soviet citizen than in the previous estimates. Under the new assumptions, a Soviet citizen (family) with an 18,000 (36,000) ruble income has the same absolute level of income as an American citizen with $2,250 ($4,500) and a British citizen with £500 (£1,000). In this case the following type of revision of Table VII would be necessary:

TABLE VII

COMPARATIVE TAX LIABILITIES OF FAMILIES WITH TWO CHILDREN: UNITED KINGDOM, UNITED STATES AND UNION OF SOVIET SOCIALIST REPUBLICS, 1956

Fraction of Average Income	Incomes			Effective Tax Rates as Per Cent of Income						
				U.S.S.R.					U.K.	
				Worker		Professional				
	U.S.S.R. (rubles)	U.S. ($)	U.K. (£)	1 Earner	2 Earners	1 Earner	2 Earners	U.S. Joint Return *	1 Earner	2 Earners **
Half	4,500	2,250	250	2.5%	1.0%	6.4%	3.1%	0	0	0
Average	9,000	4,500	500	6.3	3.7	12.3	6.2	7.5%	0	0
Twice	18,000	9,000	1,000	10.0	6.8	19.2	12.1	13.1	9.0%	6.6%
Ten-fold	90,000	45,000	5,000	12.8	12.3	40.8	31.9	34.3	44.0	40.0
Forty-fold ...	360,000	180,000	20,000	13.3	12.8	51.7	47.9	63.6	75.0	74.6

* Standard deduction taken into account.
** Assuming husband earns 60 per cent and wife 40 per cent of total income.

TABLE VIII

COMPARATIVE TAX LIABILITIES UNDER "ABSOLUTE" INCOME CATEGORIES: A SAMPLE

	Union of Soviet Socialist Republics				United States	United Kingdom
	Worker		Professional			
	1 Earner	2 Earners	1 Earner	2 Earners	Joint Return	1 Earner
$2,250 (= £500 and 18,000 rubles)	10.0	6.8	19.2	12.1	0	0
$4,500 (= £1,000 and 36,000 rubles)	11.9	10.1	28.0	18.4	7.5	9.0

Clearly, on an absolute income basis, the Soviet household pays a much higher rate of tax than its Western contemporaries at income levels which in the West are not high. Comparison with U.S. and British rates would soon overtake the Soviets because the latter are already paying maximum marginal rates at the $4,500 level. However, because of lack of reliable data on relative stand-

CHART III.
COMPARATIVE TAX LIABILITIES OF FAMILIES WITH ONE EARNER AND TWO CHILDREN: U.K., U.S., AND U.S.S.R.; 1956 (FROM TABLE VII.)

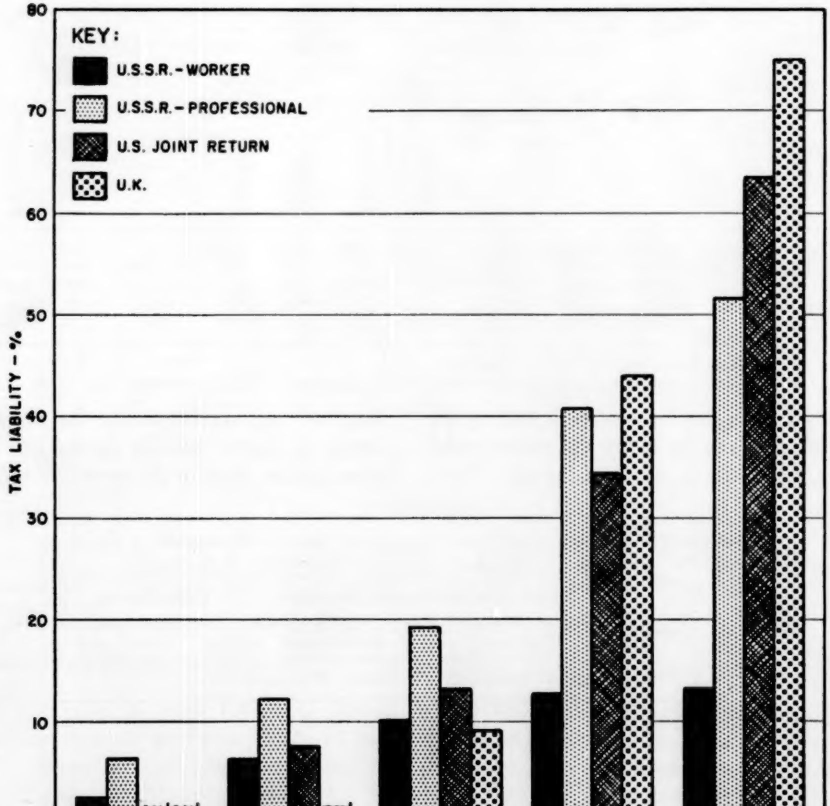


Table VII indicates that the position of the Soviet household is worse when viewed on an absolute rather than relative income basis. At still higher absolute levels of income, of course, the ards of living between nations and because of ignorance of the precise relationship between " burden " of tax and standard of living, it does not seem worthwhile to work out Table VIII in

greater detail.

In conclusion, it should be reiterated that the Soviet income tax is a relatively unimportant part of that nation's fiscal structure and that the average Soviet citizen pays out to the state in sales taxes (which appear to be neither strongly progressive nor regressive, but probably roughly proportional) about 40 per cent of his annual income.[20]

[20] Cf. *Soviet Taxation*, chaps. 6, 10.

THE COST OF FEDERAL MONEY, HELLS CANYON AND ECONOMIC EFFICIENCY

Part II

OTTO ECKSTEIN AND JOHN V. KRUTILLA *

I. *Application of Our Results to the Hells Canyon Case*

IN AUGUST 1955, the Federal Power Commission licensed Idaho Power Company to undertake a three-dam development in the Hells Canyon Reach of the Snake River. The Idaho Power Company's plan would fully develop the 602 feet of fall in that reach of river. This would provide for an initial installation of 783,400 kilowatts of capacity, and somewhat over a million kilowatts ultimately. The present generating capacity of Idaho Power Company's system is 374,000 kilowatts, or only about 30 per cent of the total capacity of the initial installation. The reservoir behind Brownlee Dam, the uppermost of the Idaho Power Company dams, would provide a million acre-feet of usable storage for flood control, provide some stream regulation for navigation, and contribute to the generation of run-of-river power installations downstream.[1]

The Idaho Power Company three-dam plan pre-empts the site of the " High " Hells Canyon Dam, proposed for construction by the Bureau of Reclamation. The High Dam represented a key structure in the U.S. Corps of Engineers' main control plan for the comprehensive development of the Columbia and its tributaries. As contemplated by the Bureau of Reclamation, the High Dam would have been a monumental, concrete arch dam which would also have fully developed the 602 feet of fall in the Hells Canyon Reach, providing 800,000 kilowatts of installed capacity originally, and 900,000 kilowatts ultimately. The 3.8 million acre-feet of storage contemplated in connection with the High Dam would warrant installation of 774,000 kilowatts of additional capacity at downstream structures on the lower Snake and Columbia rivers. The planned total of some 1.6 million kilowatts was destined for incorporation into the Bonneville Power Administration's system and, upon completion,

* The authors are, respectively, Assistant Professor, Department of Economics, Harvard University; and a member of the staff of Resources for the Future. This paper is based on Chapters IV and V of the study by the authors, *Multiple Purpose River Development: Studies in Applied Economic Analysis*, to be published for Resources for the Future by The Johns Hopkins Press.

Editor's Note: Part I of this paper, which was published in the last issue of this *Journal*, derived an estimate for the opportunity cost of federal funds raised by taxation. This cost, as measured by two specific models of tax changes, was found to be in the range of 5 to 6 per cent. It was argued that such a rate might properly be used in efficiency criteria for public investment decisions. Part II of the paper applies this interest rate in an analysis of the Hells Canyon project. It also indicates the other considerations that led to the formation of the alternative plans of the private and public groups, and evaluates them from the point of view of economic efficiency.

[1] We assume these to be the following (either existing, under construction, or proposed) federal installations: McNary, John Day, The Dalles, Bonneville, Ice Harbor, Lower Monumental, Little Goose, and Lower Granite.

would have represented approximately 16 per cent of the system's total.

An important consideration in evaluating the alternative plans for developing the Hells Canyon Reach is: Which represents the more efficient scheme of development? We approach an answer to this question by comparing the estimates of costs and gains, as provided in the record of the FPC hearings,[2] which preceded the issuance of the license to Idaho Power Company.

Some uncompensated gains would accrue from the development of either plan. However, since our present interest centers on economic gains, whether or not they appear on the private financial accounts of the enterprise, we first evaluate the plans for three dams and the High Dam as if they were being considered for development by a public agency. Moreover, to translate the physical characteristics of the respective plans into relevant economic magnitudes, we will rely on standard techniques of benefit-cost analysis.

Costs and Benefits of Public Development of a High Dam and Three Low Dams. Numerous estimates of construction costs for each plan were presented by the expert witnesses during the FPC hearings. For the High Dam, we use the construction costs appropriate to the design standards traditionally reflected in structures of the Bureau of Reclamation and other federal agencies. On the other hand, we accept estimates of construction costs appropriate to the design standards of the private utility for the three-dam plan. Although these standards are considerably lower than those employed by the federal agencies,[3] they were judged by the FPC staff to be adequate.[4] Accordingly, their relatively lower construction costs are taken to reflect an appropriate response to economic considerations. In both cases, however, the estimates of construction costs presented by the two parties were adjusted by the FPC staff to achieve comparability in terms of estimated unit costs for like items employed in construction.[5]

The relevant cost data, based on the FPC staff's adjustments, are given as annual average equivalents for the two plans in Table I. To simplify analysis we take our opportunity cost of 5-6 per cent as 5.5 per cent for computational purposes.[6] The resulting estimates show that the annual cost of the Hells Can-

[2] The data for analysis were drawn from the Federal Power Commission's voluminous record of the case—extendinig from December 1950 to the issuance of the license in August 1955—*In the Matters of Idaho Power Company; Project No. 1971, No. 2132, and No. 2133,* including, particularly: *Transcript of Hearing, Exhibits, Brief of Commission Staff Counsel,* and *Decision.* At the outset of this task, we must acknowledge that our analysis can provide results no better than the data on which it is based—and that the precision, relevance, and accuracy of data which can be culled from the record of a public hearing often leave something to be desired. In spite of limitations of this sort, there are a number of illustrative uses to which our result can be put fruitfully.

[3] FPC record, *op. cit.: Exhibits,* No. 186, pp. 25a-26.

[4] The fact that one of the Idaho Power Company's coffer dams subsequently washed out while the middle Snake was flooding, does not necessarily contradict the judgment of the FPC staff. It has been implied by the former FPC Chairman to have resulted from a departure from standards by the utility.

[5] FPC record, *op. cit.: Staff Brief,* Appendix B, pp. 18-24; Appendix B, Table 14.

[6] Evaluation of alternative plans, conducted at the hearings before FPC's presiding examiner, employed an imputed interest rate of 2.5 per cent, which is more consistent with agency practices in this area. If such a rate had been imputed to our data, the annual costs would have been respectively $15.9 million and $9.5 million for the High Dam and three low dams; and the incremental cost of the High Dam, $6.4 million. For a detailed treatment of these points, see John V. Krutilla and Otto Eckstein, *op. cit.*, Chapter V.

yon High Dam ($28.9 million) would exceed corresponding costs for the three low dams ($15.8 million) by approximately $13 million.

Annual benefits will be accounted for predominantly by power, although flood control and navigation contribute modestly to the total. Power output from the development will vary, depending on such factors as the time profile of storage capacity added at different points to the system and the depletion of stream flows associated with irrigation withdrawals upstream. The record, thus, contains numerous dissimilar estimates of power output which arise out of differences in assumptions governing the determining variables. In order to achieve comparability among plans of development, we have attempted to secure estimates based on common assumptions which reflect a consensus of expert witnesses as to reasonableness of technical assumptions, appropriateness of measures used, etc.[7]

In the Pacific Northwest, served basically by hydroelectricity, estimates of prime power appear to be the most relevant.[8] But different basic assumptions will alter the estimated total power output for both plans of development in Hells Canyon. Several methods are available. First, we could use either an estimated average length of critical period and estimated depletion, generally accepted as reasonable by the experts. Or we could use an estimated average annual prime power output, based on changes in critical period and stream flows during the time span. Or,

[7] Even so, our results should be regarded as useful in clarifying some of the basic factors underlying efficient multiple purpose development of storage sites, rather than a definitive determination of *the* most efficient plan of development for Hells Canyon.

[8] FPC record, *op. cit.: Decision*, p. 45.

TABLE I

COMPARATIVE COSTS OF HELLS CANYON HIGH DAM AND THREE LOW DAMS, ASSUMING PUBLIC DEVELOPMENT

Item	Alternatives (thousand dollars)	
	High Dam	Three Low Dams
Investment [a]	428,943	217,728
Interest and amortization [b]	23,721	12,040
Interim replacements [c]	1,545	1,074
Payment in lieu of state and local taxes [d]	2,145	1,089
Operation and maintenance [e]	1,495	1,666
Total average annual costs	28,906	15,869
Increment of average annual costs of High Dam over three low dams	13,037	

[a] The investment figure was obtained as follows: For the High Dam—(1) construction costs at site, $310,740,000 (Federal Power Commission record *In the Matters of Idaho Power Company; Project No. 1971, No. 2132, and 2133: Brief of Commission Staff Counsel*, Appendix B, Table 14; (2) construction costs for downstream generating capacity, $58,707,000 (Witness Cotton's estimate, *ibid.*, Appendix A, p. 29); (3) interest during construction at site estimated on one-half the construction cost over a six-year construction period, at 5.5 per cent per annum; (4) interest during construction for downstream installations of generators estimated on one-half the construction cost over a two-year construction period at 5.5 per cent per annum; (5) estimate for capital cost of facilities for migratory fish of $5 million (*ibid.*, Appendix B, Table 14). For the three low dams—(1) construction cost at site of $186,941,000 (*ibid.*); (2) construction cost for downstream generators of $13,862,000 (*ibid.*, p. 31); (3) interest during construction at site estimated on one-half the construction cost over a 2.8-year average construction period at 5.5 per cent per annum; (4) interest during construction for installation of downstream generators estimated at one-half the construction cost over a two-year period at 5.5 per cent per annum; (5) estimated capital cost of facilities for migratory fish of $5 million (*ibid.*, Appendix B, Table 14).

[b] Interest at 5.5 per cent and amortization schedule of one hundred years.

[c] *Ibid.*, Appendix B, p. 87.

[d] *Ibid.*, p. 88.

[e] *Ibid.*, pp. 89-90.

finally, we could move to a somewhat different method by comparing time streams of estimated inputs and outputs. For our purpose, we have employed the first method—largely because this enables us to cull from the record the maximum relevant data, which are both consistent among plans of development and useful in illustrating various aspects of the total problem.[9]

Table II details annual benefits, and their average annual monetary equivalents, of the High Dam and the three low dams. At the site of development, benefits are accounted for by 647,000 kilowatts of prime power generated at the High Dam and 585,000 kilowatts at the three dams, as well as a certain amount of navigation services provided on the reservoirs themselves. Downstream benefits will accrue from increased prime power at eight installations (314,000 kilowatts resulting from the High Dam and 117,000 from the three dams), and from flood control and navigation benefits on the lower Snake River and lower reaches of the Columbia River. Total benefits of $42.8 million annually available from development by means of the High Dam are approximately $12 million more than the annual average available from development of the three-dam alternative.

The more efficient scheme of development is revealed by comparing the added benefits and the added costs of the High Dam over the three-dam alternative; the $13 million in added cost of the High Dam would exceed the $12 million in added benefits.[10] The incremental benefit cost ratio just falls short of unity. It is conceivable that the High Dam would be justified by its

TABLE II

AVERAGE ANNUAL VALUE OF PROJECT SERVICES OF HELLS CANYON HIGH DAM AND THREE LOW DAMS, ASSUMING PUBLIC DEVELOPMENT

Item	High Dam	Three Low Dams
	(kilowatts)	(kilowatts)
Prime power [a]		
At site	647,000	585,000
Downstream	314,000	117,000
Total	961,000	702,000
	(thousand dollars)	(thousand dollars)
Value of prime power at $41.58 per kw.[b]		
At site	26,902	24,324
Downstream	13,056	4,863
Increment to system	39,958	29,187
Value of flood control benefits [c]	2,600	1,400
Value of navigation benefits [d]	250	100
Total average annual value of project service	42,808	30,687
Increment of average annual benefits of High Dam over three low dams	12,121	

[a] FPC record, *op. cit.: Staff Brief,* Appendix A, pp. 14, 17. Assumes depletion flows associated with 366,650 additional acres to be irrigated, a 32- to 34-month critical period, and operation of the facilities under conditions of hydraulic integration.

[b] *Ibid.,* p. 14; FPC record, *op. cit.: Decision,* p. 47.

[c] FPC record, *op. cit.: Exhibits,* No. 372.

[d] *Ibid.*

9 In general, while different methods or basic assumptions will yield different estimates for *total* output of project services, this is of no great importance if the *differences* between plans remain unchanged. Where changes in basic assumptions or approach do affect conclusions significantly, we also introduce those results for comparative purposes.

10 It must be acknowledged this conclusion is particularly affected by the set of data which is employed. We have used Witness Cotton's estimate of prime power output, equivalent to 961,000 and 702,000 kilowatts, respectively, for the High and

(See next page)

greater recreational values—for which there are no adequate estimates of monetary value commensurate with other data employed in our analysis. It is apparent that for any reasonable estimate of the increased recreational value attributable to the High Dam, however, the added $211 million of investment would represent a substantial churning of economic activity, income redistribution, etc. While there may be no net loss resulting, there would not be any clearly demonstrable gain. If an opportunity cost of 5.5 per cent is attributed to the capital funds raised for development of the Hells Canyon reach, therefore, there is no clear-cut evidence that the three-dam scheme is less efficient than the High Dam.

Feasibility of an Intermediate, Two-Dam Plan. Since plans for the High Dam and three dams are so nearly equal in comparative efficiency, despite their vast differences in scale, it appears that the resources committed to the development of the added benefits from the High Dam would be employed over some range of diminishinig total net returns. A plan of development intermediate between the two, therefore, may be economically superior to both. Details of such a plan of development were considered at the FPC hearings.[11] This intermediate plan involves two structures—a dam of medium height (325-foot head) to occupy the site proposed for the High Dam, and a second dam identical in location and characteristics to the Brownlee Dam proposed by Idaho Power Company.[12] Together, the two dams would provide up to 1.3 million acre-feet of usable storage, develop 602 feet of head, and provide for initial installed generator capacity at site of 783,000 kilowatts. This plan is intermediate in size in the sense that it would provide more storage than the three-dam plan, and would permit a greater amount of power generation downstream, more flood control, and more im-

three low dams. This is consistent with an average depletion of stream flows associated with an average of 366,650 additional acres of upstream irrigation and a critical period of 32 to 34 months. Employing Cotton's estimates expressed as average annual prime power, the output appropriate to the two alternatives would be, respectively, 839,100 and 598,000 kilowatts. Although the total annual benefits ($38,739,000 and $26,365,000, respectively) would be smaller than those appearing in the text, the *difference* between the High and low dams ($12.4 million) would be larger. Even so, the incremental benefit to cost ratio would not exceed unity. A criticism of this result relates to the fact that the conclusion is based on data employing a 50-year annual average, whereas additional depletion of stream flows may occur during the remaining 50 years of the amortization period. As a rough check, we can use data presented by Witness Riter which are consistent with Cotton's estimates, save for failure to include additional power output resulting from system integration and an estimated higher rate of additional irrigated acreages. Riter's estimates for increased acreages under irrigation (1,140,000 acres by the end of the amortization period, or an average of 631,000 for the time span) is approximately double that of Cotton's, which is taken from the commonly accepted estimates of the Columbia Basin Interagency Committee. Accordingly, we can consider Riter's estimates as appropriate to the hundred-year amortization schedule, and approximate results in the following manner. Prime power output was estimated by Riter to fall from 1,108,000 kilowatts initially to 679,000 by the end of the amortization period, for the High Dam; and from 660,000 initially to 509,000 ultimately, for the three low dams. If we assume that the decrements in each case occur in equal annual amounts, we can infer the time distribution of the total prime power output and obtain the present value of the stream of benefits when discounted at our 5.5 per cent. Similarly, the annual operating and maintenance costs can be discounted to the present and added to the original investment. The resulting difference in present value of the stream of benefits from the alternative plans of development approximates $317 million, compared with a difference in costs of $287 million. The ratio of the added benefits to added costs, accordingly, is 1.3:1.

[11] FPC record: *Exhibits, op. cit.*

[12] FPC record: *Staff Brief, op. cit.*, pp. 6-7; Appendix A, pp. 3-4. See also FPC record: *Exhibits, op. cit.*

provements to navigation downstream. In terms of investment outlays and annual costs, however, it is the smallest of the three plans.

The estimated annual average benefits from the intermediate, two-dam plan are shown in Table III; estimated annual costs, imputing an opportunity cost to capital of 5.5 per cent, are shown in Table IV. The average annual benefits of the two-dam plan exceed the costs by a ratio of 2:1.

TABLE III

AVERAGE ANNUAL VALUE OF PROJECT SERVICES OF BROWNLEE AND MEDIUM HEIGHT HELLS CANYON DAMS, ASSUMING PUBLIC DEVELOPMENT

Item	Two Dams
	(kilowatts)
Prime power[a]	
At site	566,000
Downstream	145,000
Total	711,000
	(thousand dollars)
Value of prime power at $41.58 per kw.[b]	
At site	23,534
Downstream	6,029
Increment to system	29,563
Value of flood control benefits[c]	1,800
Value of navigation benefits[d]	150
Total average annual value of project services	31,513
Increment of average annual benefits of High Dam over two dams	11,295

[a] Estimates of nominal prime power were taken from Witness Meadowcroft's estimate (FPC record, *op. cit.: Staff Brief*, Appendix A, p. 16) adjusted to conform with estimates for the High Dam and three dams (i.e., a 32- to 34-month critical period, 366,650 additional acres irrigated, and all down-stream generation credited to Hells Canyon reach) to achieve results based on assumptions consistent among the three plans.

[b] *Ibid.*, p. 14; FPC record, *op. cit.: Decision*, p. 47.

[c] FPC record, *op. cit.: Exhibits*, No. 372.

[d] *Ibid.*

The added benefits of the Hells Canyon High Dam over the two-dam alternative amount to approximately $11.3 million as an annual average, but the annual costs of the High Dam are about $13.5 million more than costs of the two-dam plan. The added benefits of the High Dam fall short of compensating for the added costs.[13] However,

TABLE IV

COMPARATIVE COSTS OF BROWNLEE AND MEDIUM-HEIGHT HELLS CANYON DAMS, ASSUMING PUBLIC DEVELOPMENT

Item	Two Dams (thousand dollars)
Investment[a]	212,461
Interest and amortization[b]	11,749
Interim replacements[c]	961
Payment in lieu of state and local taxes[d]	1,062
Operation and maintenance[e]	1,625
Total average annual costs	15,397
Increment of average annual costs of High Dam over two-dam intermediate plan	13,509

[a] The investment figure was obtained as follows: (1) construction costs at site of $177,935,000 (FPC record, *op. cit.: Staff Brief*, Appendix B, Table 14); (2) construction costs associated with downstream generating capacity, $13,862,000; (3) interest during construction of $14,680,000, at 5.5 per cent over a three-year construction period; (4) interest at $774,000 on downstream installation of generators, two-year installation period; (5) estimated capital cost of $5 million for facilities to permit passage of migratory fish.

[b] Interest computed at 5.5 per cent over a hundred-year amortization schedule.

[c] *Ibid.*, p. 88.

[d] *Ibid.*

[e] *Ibid.*, p. 89.

[13] If we use Riter's estimates for the prime power output of the two-dam scheme, which drops from an original of 677,000 to 508,000 kilowatts of prime power by the end of the amortization period, we find the added benefits just compensating for the

(See next page)

the evaluation of these alternative plans is quite sensitive to the choice of data, both the physical output and value per kilowatt, as well as to the assumed time distribution and the discount factor. Thus to a large extent, the conclusions are conditioned on imponderables; there is no definitive *ex ante* answer as to whether the High Dam or the two dams would be more efficient.

There is a considerably more clear-cut case, when the two-dam and three-dam plans are compared. The two-dam plan would provide more power, flood control, and navigation benefits than would the three-dam plan. These benefits are estimated to total around $825,000 more, as an annual average, than the value of output from the three-dam plan. Coupled with this, total investment for the two dams would be around $5 million less, and annual costs about $472,000 less than for the three-dam scheme.

Analysis of Two and Three Dams, Assuming Construction and Operation by Idaho Power Company. In view of the marked superiority of the two-dam plan as compared with the three-dam plan, the question arises: Why did Idaho Power Company seek a license for construction of three dams instead of the socially more efficient two-dam alternative? An answer to this question must take into account the divergence between private and social marginal productivities of resources. The economic superiority of the two-dam alternative partly results from the increased downstream generation—28,000 kilowatts—for which a private enterprise could not collect compensation.[14] The increased storage available for flood control and navigation—which also are essentially nonmarketable services—would not be

TABLE V

COMPARATIVE COSTS OF TWO-DAM AND THREE-DAM ALTERNATIVES, ASSUMING PRIVATE DEVELOPMENT

Item	Two Dams (thousand dollars)	Three Dams (thousand dollars)
Investment[a]	196,280	201,817
Interest and amortization[b]	10,752	11,055
Interim replacement[c]	893	1,074
Federal corporate taxes[d]	6,379	6,559
State and local taxes[e]	2,944	3,027
Operation and maintenance[f]	1,625	1,666
Insurance[g]	196	202
Total average annual costs	22,789	23,583
Increment of average annual costs of three dams over two dams	......	794

[a] Construction cost taken from FPC record, *op. cit.: Staff Brief*, Appendix B, Table 14; with interest during construction at 5 per cent; and construction outlays exclusive of provision for downstream generators.

[b] Interest at 5 per cent (*ibid.*, p. 94); amortization over 50 years.

[c] *Ibid.*, pp. 87-88.

[d] Assumes marginal tax rate of 50 per cent, rate of return of 6.5 per cent after taxes on venture capital comprising 50 per cent of the capitalization.

[e] Assumes a rate at 1.5 per cent on investment.

[f] *Ibid.*, p. 89.

[g] *Ibid.*, p. 88.

added costs. Discounting the annual operating and maintenance costs for the two plans, we get a difference in current costs of $284 million between the two plans. The difference in present value of benefits approximates $307 million when both streams are discounted at 5.5 per cent. The incremental benefits to cost ratio, in terms of these data and evaluation methods, would approximate 1.1:1, tending to favor slightly the High Dam.

[14] Since the hydroelectric potential of sites along navigable streams is a public asset (see *United States v. Chandler-Dunbar Co.*, 229 U.S. 53, reaffirmed in the recent Supreme Court Opinion, *United States v. Twin City Power Company*, No. 21, October Term, 1955), increased generation at federal power installations resulting from the development of storage by private licensees need not be compensated for by the federal government. This is expressly recognized in the Federal Power Act of 1920.

given much weight in private investment decisions. In short, for Idaho Power Company, only the at-site power generation would appear relevant. Accordingly, if we assume the same at-site value attaches to power produced in this case as in the analysis of publicly developed plans, the financial returns to Idaho Power Company from the three-dam plan would approximate $24.3 million annually, about $800,000 more than the two-dam alternative. Annual costs for the three dams, figured on the basis of cost items appropriate to a private venture as given in Table V, would be about $794,000 higher than for the two-dam plan.

Evaluated in terms of the private cost-gains calculus, the added financial returns from the three-dam plan would almost compensate for the added costs—but without any clearly demonstrable advantage. It is not clear, therefore, that the decision in favor of the three-dam plan was reached in terms of the factors we have considered.

In the analysis of comparative efficiency involving public development of different Hells Canyon dams, we employed an estimate of $41.58 as the value of prime power per kilowatt. We also assumed power output consistent with operations under conditions of complete hydraulic and electrical integration for a system of which the Snake River is but a part. While both of these assumptions are appropriate for evaluating the different plans under public operation, where incremental social costs and gains are compared, they are not useful for understanding the investment choice facing the private firm.

The at-site value of power was derived by the FPC staff by estimating the lowest cost of alternative non-hydroelectric power, on the assumption that the alternative power would be provided by some public body employing an imputed interest rate of 2.5 per cent.[15] While this estimate of the value of power may be appropriate in comparing the economics of different plans, it has no particular significance for estimating returns on investment by an electric utility. The rates for utilities are traditionally established through public regulation by means of a cost-plus formula. The rates at which Idaho Power Company could expect to market its power, within the territory it has been franchised to serve, would be such as to compensate it for all operating expenses plus a reasonable return on prudent investment. However, there is a serious complicating factor in this instance.

The market which Idaho Power Company is franchised to serve is very small in relation to the power potential in the Hells Canyon Reach. The present generating capacity of the Idaho Power Company system would be more than tripled by the 783,400 kilowatts of planned initial generating capacity in Hells Canyon. A large block of the new capacity would not become fully utilized for two decades, if its use were restricted to servicing the Idaho Power Company's domestic market.[16] On the other hand, if Idaho Power Company attempted to market this surplus outside its franchised territory, it could not sell

[15] FPC record: *Decision, op. cit.*, pp. 21-22, 25. Whether or not this appears to be the most appropriate manner by which to estimate the value of prime power, the figure of $41.58 per kilowatt year appears defensible on other grounds. Power sells for from $17.50 per kilowatt-year in some sub-markets of the Northwest to over $70.00 for other portions of the regional demand. If we assume that this represents discriminatory pricing under a linear demand function, the average value can be approximated by the midpoint between the two prices—or something in excess of $43.00 per kilowatt.

[16] *Ibid.*, p. 23 ff.

at a rate which would return full cost in the remainder of the Northwest Power Pool, in spite of conditions of tight power supply. The northwest has a public power tradition, in which agents of state and local governments can provide power at lower rates than can a private utility. This is accounted for largely by lower operating costs, stemming from the advantages enjoyed by public bodies as a result of the doctrine of intergovernmental tax immunity. Supplies of power developed by such public bodies, accordingly, would be more attractive to users than the potential Hells Canyon surpluses of Idaho Power Company.[17] Moreover, it seems unlikely that the Idaho regulatory authority would grant Idaho Power Company the privilege of making up any deficiency in revenues on its export power by increased charges on its domestic customers.[18]

The scale of development which Idaho Power Company can undertake profitably, therefore, is restricted by such institutional factors as the more favorable terms under which publicly developed sources can be obtained in the area and the limitation on the market territory which it is exclusively franchised to serve—in conjunction with the sheer amount of hydroelectric power in the Hells Canyon development. In view of these cost and marketing considerations alone, it appears that a private developer—choosing between a more efficient two-stage plan which would create surplus power over a longer period of time, and a three-stage plan in which the capacity could be brought into production more gradually—would select the socially less efficient scheme of development.

A further factor, which would influence the private utility's decision, is the plan of operation. The actual at-site power generation would be somewhat different for both plans when operated by an independent private utility, than the estimates presented in Tables II and III. The above estimates assumed that storage capacity developed in Hells Canyon would be utilized, along with other reservoirs in the river system, so as to maximize the value of output for the entire regional power system, irrespective of the effect on an isolated installation or set of facilities in a sub-system.[19] Under Idaho Power Company management, the operating rule curve for the reservoir would strive for high at-site generation and peaking capability at its three dams, independent of its effects on the output of other interdependent units of the hydraulic system.[20] Neither does Idaho Power Company contemplate the transmission facilities necessary to permit taking full advantage of the technical possibilities for complete hydraulic and electrical integration with the remaining systems in the Northwest.[21] Operation of the reservoir would involve annual drawdown and refilling operations rather than storage utilization over the total hydraulic system's critical period of two to three years.[22]

What is the economic significance of this decision in quantitative terms? First, the annual costs associated with the lesser investment in the two-dam plan of operation would approximate

17 *Ibid.*, p. 25; Finding No. 23, p. 35.

18 *Ibid.*, p. 26.

19 See Table XI, footnote a.

20 Testimony of Witness Hogg for Idaho Power Company, FPC record, *op. cit.*: *Transcript of Hearing*, pp. 3494-95, 5658-59, 5710, 5716, 5729-30, 5758, and 6130-31.

21 FPC record: *Decision*, *op. cit.*, Finding No. 139, p. 64.

22 Testimony of Witness Hogg, *op. cit.*, pp. 5716, 5729-30.

$422,000 less than for the three-dam plan (see Tables I and IV). Increased power generation from the two dams would amount to about $374,000 annually.[23] Furthermore, increases amounting to approximately $400,000 in average annual flood protection and $50,000 in average annual navigation benefits would be realized from the two-dam over the three-dam scheme of development. In sum, the annual economic gain from the two-dam alternative would approximate $1.3 million.

These estimates of annual gains are consistent with the assumption that both plans would be operated to achieve maximum system output. This, in turn, would require that all facilities be operated under coordinated management. For example, the increase in the total river system's prime power from the three-dam scheme, operated under conditions of hydraulic and electrical integration would be 702,000 kilowatts. Of this, 585,000 kilowatts would be generated at site; 104,000 kilowatts generated at eight downstream run-of-river installations; and 13,000 kilowatts would be attributable to operation under system integration.[24] These estimates assume a cyclical storage drawdown in which the stored water would be utilized to meet deficiencies over a 32-month critical period. The estimates would be smaller if the facilities in the Hells Canyon Reach were operated independently of the constraint to achieve maximum system output. If we assume annual reservoir drawdowns, output from the three dams under independent management would approximate 567,000 kilowatts at site, and 102,000 kilowatts downstream.[25] Although these estimates are not strictly comparable with those for an integrated system,[26] potential primary generation of about 33,000 kilowatts would seem to be sacrificed by operating the Hells Canyon three-dam plan as an isolated subsystem. A net increase amounting to roughly $1.4 million annually would result from operations directed toward maximum output for the system.

The difference between the two plans of development and probable methods of operation suggests a realizable economic gain from the two-dam plan of around $2.7 million annually, over development and operation of the Hells Canyon Reach of the Snake by Idaho Power Company's preferred alternative.

II. *Conclusions and Policy Implications*

In this study we have assessed the social cost of investment funds raised by federal taxation, by discriminating carefully as to the probable sources from which they would be drawn in a particular historical context, and estimating the value of returns foregone in the private sector by the diversion of funds to the water resources field. This approach yields a substantially different estimate

[23] The added generation downstream permitted by the larger storage capacity would not require additional facilities for the two-dam as compared with the three-dam plan. See, for example, FPC record: *Exhibits, op. cit.*, No. 186, p. 28a.

[24] FPC record: *Exhibits, op. cit.*, No. 50, p. 77. These estimates are based on the assumptions that Glacier View Reservoir is eliminated and increased storage is provided at Libby as a partial offset; stream flows will be depleted consistent with an assumed increase of 366,650 acres of irrigation above Hells Canyon, and the critical period is 32 to 34 months.

[25] See FPC record: *Staff Brief, op. cit.*, Appendix A, p. 17; *Transcript of Hearing, op. cit.*, pp. 3544-45.

[26] Witness Hogg for Idaho Power Company employed reservoir operating assumptions which clearly indicated drawdown and refilling on an annual basis (*op. cit.*, pp. 5716, 5730) and operations to maximize output from an isolated development (*ibid.*, pp. 3495, 5658-59).

of the opportunity cost of federal investment funds from that developed by the conventional practice. We have followed this with a review of the several plans for the development of Hells Canyon with a view to illustrating important factors which must be taken into account, along with the opportunity cost of investment funds, to achieve efficiency in development of river projects.

system, appears to be as efficient as the High Dam.

The superiority of the High Dam would depend on a somewhat lower opportunity cost for public funds than can be justified, assuming an approach such as we have employed. However, the lack of economic justification for the Idaho Power Company plan is entirely independent of the difference in interest costs faced by private, compared with public, parties, in financing investment. That is, Idaho Power Company's three-dam plan of development requires a heavier commitment of productive resources for a smaller total benefit than does the two-dam plan, irrespective of the level of interest rates. The company's preference for the three-dam plan seems to be governed mainly by the relatively small system which it operates —at least small in comparison with the hydroelectric potential in the Hells Canyon Reach. The hydroelectric potential

TABLE VI

COSTS AND GAINS FROM INTEGRATED OPERATION OF TWO-DAM PLAN AND FROM OPERATION OF IDAHO POWER COMPANY THREE-DAM PLAN AS ISOLATED SUB-SYSTEM

Item	Operation of Three Dams in IPC Isolated Sub-System	Operation of Two Dams in Integrated Federal System	Gains from Two Dams over Three Dams
		(kilowatts)	
Average annual generation of prime power ...	669,000[a]	711,000[b]	42,000
		(thousand dollars)	
Value of prime power at $41.58 per kw.	27,817	29,563	1,746
Value of flood protection	1,400	1,800	400
Value of navigation services	100	150	50
Total average annual value of added benefits	29,317	31,513	2,196
Total average annual costs	15,869	15,397	472
Total average annual economic gains	......	......	2,668

[a] FPC record, *op. cit.: Staff Brief,* Appendix A, p. 17, Witness Hogg's estimate appropriate to an eight-month critical period.
[b] Based on Witness Meadowcroft's estimate, *ibid.*, p. 16.
[c] See Tables I and IV.

We find that the economic justification of the Hells Canyon High Dam is dependent on the opportunity cost of public funds. If an interest rate of 2.5 per cent is imputed for planning purposes—the figure employed in the FPC hearings—the High Dam seems to enjoy a marked superiority. But for an imputed interest rate in excess of 4.5 per cent, the two-dam alternative appears to be the more efficient, and at 5.5 per cent the three-dam scheme, if operated as an integral part of the regional

in Hells Canyon represents such an extreme discontinuity in the supply curve for the market which Idaho Power Company is franchised to serve, that an inferior plan was necessary to cope with the company's embarrassment of riches. Part of the superiority of the two-dam alternative, also, is accounted for by improved stream regulation, which permits increased downstream generation through turbines of fiscally independent parties, as well as increased output of nonmarketable project services which escape appropriation by pricing practices. The direct interdependence among facilities of fiscally independent parties, along with presence of collective goods, are conditions which are commonly encountered in the water resources field.

In the light of the relatively inefficient plan of development which was licensed, what alternatives might be considered for achieving more efficient development in similar or related cases?

One alternative, of course, would be to have the federal government undertake the development under provisions of the Federal Power Act. This could be defended in light of three major considerations: There is the size of the development and the enormous hydroelectric potential in relation to all but the federal system in the Pacific Northwest. Significant external economies would appear in the federal installations downstream, for which a private developer of upstream storage could not receive compensation. Finally, there would be a significant amount of nonmarketable output. The history of proposed legislation to authorize federal development of the Hells Canyon site, however, reflects a stalemate between the advocates and opponents of federal development. Such legislation has consistently failed of passage in the Congress. Moreover, since 1953, the executive branch of government has withdrawn support for development under federal auspices. Without forceful support for such development, the prospects for development as a federal undertaking appear very slight.

A second alternative would be development by either a local public body or a combination of two or more such organizations. This would be consistent with the preference provisions of the Federal Power Act, and also with the realities of financing the development at lower costs to provide power at rates attractive to electro-process industries, thereby improving the prospects for marketing profitably such a large block of new generation. In the Hells Canyon case, however, no acceptable local organizations appear to have been interested, nor did any such organization present a plan to be seriously considered by the FPC.

A third alternative would be to license, under authority of Section (10a) of the Federal Power Act, a private developer who had exhibited an intent to develop that reach of river. In this case, the FPC would have the authority, as a condition of the license, to require modification of the plan of development so that it would be best adapted to comprehensive development of the Columbia and tributary system. A private firm could then decide whether or not to undertake the development under conditions which, while representing the most efficient plan from a social viewpoint, might not be most attractive and perhaps financially feasible within a private cost-gain calculus. If the private firm found that such conditions did not warrant investment, there is a fourth alternative. Development of the Hells Canyon Reach [27] could be deferred until

27 (See next page)

a combination of circumstances altered the prospect for development by the most efficient means.

The FPC followed the third alternative, without requiring such modification of the applicant's plans as to ensure the most efficient scheme of development. If the value which the FPC attached to developing this reach of river under Idaho Power Company auspices was shared to the same extent by the body politic, we might say that by " collective choice " efficiency was here sacrificed for " higher criteria." Even so, we may consider what would achieve such higher values without sacrificing to the same extent efficiency objectives.

Because of the relative indivisibility of the site for efficient development, the direct interdependence among facilities in the total system, and the nonmarketable water derivatives, a substitution of the two-dam alternative would provide average annual economic returns approximately $2.7 million greater than the Idaho Power Company plan. That is, if there were machinery whereby the beneficiaries from the substitution of the socially more efficient two-dam plan could compensate Idaho Power Company, such compensation could approach $2.7 million annually, without leaving the beneficiaries any less well off than under present plans.

In the absence of such machinery for compensation, the gains could be realized only by resort to revenues arising outside the pricing practices of a private utility. Under certain circumstances, it is conceivable that the FPC could require the most efficient plan as a condition of the license, or could permit the privately preferable plan under penalty of charges sufficiently high to induce the private developer to prefer the socially more efficient plan. This approach may have general merit, under normal circumstances. But in the case of the Hells Canyon Reach, because of the extreme conditions encountered there, it is doubtful if this would have led to development of that reach of river. The private developer could refuse the license. The remaining alternative for obtaining private development, in the immediate future, would require a public subsidy of the private utility, to achieve the public functions inherent in the most efficient development of this reach of river.

A public subsidy could take several forms. The twin goals of private development by the most efficient plan—if these goals are sufficiently valued—could be promoted by congressional appropriations to subsidize Idaho Power Company in an amount up to the present value of the added annual benefits of the two-dam plan over the company's preferred plan. Or the value of the increased generation at federal power installations downstream conceivably could provide the wherewithal to compensate Idaho Power Company for the storage services it would develop through the most efficient scheme.

Such compensation from downstream installations, however, raises significant policy issues. Consistent with tradition, reaffirmed by several Supreme Court rulings [28] that the hydroelectric potential is a public resource, the Federal Power Act contains numerous provisions to the effect that private developers

[27] Four other hydroelectric sites upstream, aggregating a much more modest 215,000 kilowatts, were available to Idaho Power Company for development at unit costs slightly below those experienced in the Hells Canyon Reach. See FPC record: *Staff Brief*, *op. cit.*, p. 20.

[28] *United States v. Chandler-Dunbar Co., op. cit.*; *United States v. Appalachian Power Co.*, 311 U.S. 377; and *United States v. Twin City Power Company, op. cit.*

must incur costs for public purposes as compensation for the privilege of developing a resource that is owned by the public. Accordingly, in order to permit compensation of developers of private headwater storage by downstream federal hydroelectric operations, the application of the Federal Power Act would have to be modified in numerous instances. In turn, this would require major changes in existing law. In light of the wide ramifications of such a change and the conceivable relevance of "higher criteria," a judgment on the desirability of such a change remains outside the scope of this paper.[29] Nevertheless, if efficient development under private auspices is sought, arrangements similar in effect to those mentioned would be needed. The other choice, if efficiency is sufficiently valued, is to continue development of storage sites under federal auspices in those cases where the federal government owns and operates run-of-river downstream installations.

If measures were provided to require compensation from downstream beneficiaries, whether public or private, and if the machinery to collect such compensations were adequate, one further modification of customary practice in the Columbia River Basin would be required to achieve efficiency. The most efficient design of installations consistent with integrated system development, while necessary, is not enough to ensure economic efficiency in the management of multiple purpose river basin systems. Operation of all of the interdependent units of the system, irrespective of ownership, must be coordinated to maximize the value of the system's potential. This, in turn, would require that all facilities be operated under unified management. For example, the difference in power output between the identical three-dam facilities operated as an isolated sub-system and operated as part of an integrated Columbia system is estimated at about 33,000 kilowatts in Table VI. Thus a net gain, estimated roughly at $1.4 million, would result annually from operating the facilities in the Hells Canyon Reach under integrated management, along with other units of the interdependent Columbia system. Sharing the gains available under coordinated management would provide an incentive to both parties—Idaho Power Company and the federal power system—to transfer the management responsibilities for the storage reservoirs on the Snake River to the agency responsible for the federal system.

A precedent for such a cooperative arrangement is to be found in the Fontana Agreement negotiated between Tennessee Valley Authority and Aluminum Company of America. The company transferred management responsibility for its reservoirs on the Little Tennessee to the TVA in exchange for sharing equally in the added power (22,000 kilowatts) made available through integration.[30]

It appears appropriate to observe that where excellent storage sites exist upstream from federal power installations, partnership arrangements involving private development do not, in the absence of a much greater degree of experimentation, promise the ultimate in efficient development.

29 For a discussion of some of the issues involved, see *Headwater Benefits*, Hearings before the Subcommittee on Irrigation and Reclamation of the Committee on Interior and Insular Affairs, United States Senate, 84th Congress, 1st session, on S. 1574, May 27, June 29, and July 12, 1955.

30 Tennessee Valley Authority, *The Fontana Project*, Technical Report No. 12, 1950, p. 7.

Finally, while our estimate of the opportunity cost of federal funds has been confined to the field of water resources in this study, its application can be extended fruitfully to many other areas of public expenditures. Wherever decisions are made to commit public capital, the cost of that capital should include an interest charge that, at the least, reflects the opportunity cost of the tax money in the private sectors of the economy—a rate in excess of 5 per cent.

VETERANS' PROPERTY TAX EXEMPTIONS

McGEHEE H. SPEARS *

IN THOSE state legislatures that were in session in the first half of 1957, 26 legislative proposals dealing with veterans' property tax exemptions were introduced. Although few were enacted, the number of such legislative proposals, together with the fact that in no state was legislation introduced to narrow or abandon the veterans' property tax exemption, suggests the increasing importance of this tax policy. The growth of veterans' property tax exemptions in turn raises questions concerning the fiscal effects of this tax policy on the general property tax as a major revenue producer for the financing of local governments.

As of July 1, 1957, 28 states grant a property tax exemption to veterans. The major legal provisions in each state are presented in Table I. In 16 states, the exemption includes both the veterans' real and personal property. Eleven states exempt real property only, and one allows exemption for personal property only. Seven of the 28 states—Arizona, Iowa, Louisiana, Michigan, Nevada, New Mexico, and Oklahoma—extend a property tax exemption to all eligible veterans whether or not they are disabled. In 14 states—Alabama, Arkansas,[1] Florida, Idaho, Indiana, Maine, Maryland, Massachusetts, North Dakota, Oregon, South Carolina, Tennessee, Utah, and Vermont—the property tax exemption is granted to disabled veterans only. In the remaining seven states—California, Connecticut, New Hampshire, New Jersey, New York, Rhode Island, and Wyoming—the law allows a larger amount of exemption to the disabled than to other non-disabled veterans.

Six states require, as a condition for eligibility, that the assessed value of all property owned by the veteran must not exceed a stipulated amount. For example, the property tax exemption is granted in Arizona, California, and New Hampshire only to veterans whose property does not exceed $5,000 in value. In Idaho, the property must not exceed $3,600 in cash value and the veterans' annual income cannot exceed $3,600. In Michigan and Oregon, the taxable value of real and personal property must not exceed $7,500.

In general, the veterans' tax exemption applies to the property tax levies of both state and local governments. However, as several of the states shown in Table I have abandoned the use of the property tax, while others collect only small amounts of state revenue from this source, the veterans' tax exemption applies chiefly to the local property tax levies. Special assessments for such capital expenditures as irrigation, drainage or sewers, are levied

* The author is an Agricultural Economist with the U. S. Department of Agriculture.

[1] For all practicable purposes, the tax exemption extended to disabled veterans in Arkansas is ineffective. The state property tax repealed in 1947 was the only levy to which this exemption applied.

TABLE I

Major Legal Provisions of State Veterans' Property Tax Exemptions, 1957

States	Amount of Exemption Extended to Eligible Veterans	Amount of Exemption Extended to Disabled Veterans	Legal Authority for Exemption	Recent Revisions in Legal Authority	Property Tax Levies Included in the Exemption
Alabama [1]	.....	$3,000	Sec. 2(p), tit. 51, code	1940, 1947	All
Arizona [2]	$2,000 [a]	.....	Sec. 2, art. 9, Const.	1946	All
Arkansas [3]	.....	The Homestead and Personal Property	Sec. 84.209-212, Ark. Stat.	1947	State
California [4]	$1,000 [a]	$5,000 [b]	Sec. 1¼, art. XIII, Const.	1944, 1954	All
Connecticut [5]	$1,000 [a]	$3,000 [a, b]	Sec. 1761, 1766, 1768, 1769, 1772, ch. 86, tit. XV, code	1949, 1951, 1953, 1955	All
Florida [6]	.....	$500	Sec. 9, art. IX, Florida Const.	1948, 1953	All
Idaho [7]	.....	The Homestead	Sec. 63-105, tit. 63, ch. 1, code	1947, 1949	All
Indiana [8]	.....	$2,000 [a]	Sec. 1, ch. 95, Laws, 1941	1927, 1933, 1943, 1947	All
Iowa [9]	Contingent on when service was performed [a]	.....	Sec. 427, 3 code	1946, 1947, 1949, 1955	All
Louisiana [10]	$5,000 [a]	.....	Sec. 4, art. X, Const.	1947, 1952, 1956	State, Parish, special taxes

[a] If the veteran is deceased the tax exemption is usually extended to the eligible unmarried widow and minor children. In certain states, this exemption can be extended to the veteran's father or widowed mother.

[b] Amount of disabled veterans' tax exemption is in lieu of tax exemption granted to non-disabled veterans.

[1] Extended only to certain incompetent veterans. 1947 amendment increased the amount of the exemption from $2,000. Exempt from all real and personal property taxes.

[2] Exemption extended only if veteran's total property assessment does not exceed $5,000 in value. Exempt from all real and personal property taxes.

[3] State tax on all property repealed by Act 110, Laws, 1947. For all practicable purposes, this exemption is inoperative as this was the only tax levy included in the exemption.

[4] The $1,000 tax exemption extended if total value of veteran's property does not exceed $5,000 in value. The $5,000 exemption extended on the home in lieu of the $1,000 exemption. Property is exempt from all property taxes.

[5] The $1,000 exemption extended on veteran's real estate only. Exempt from all real property taxes.

[6] This exemption extended to every widow and person who has lost a limb or has been disabled by war or misfortune. Exempt from all real and personal property taxes.

[7] This exemption extended only if property is owned and occupied as a home, and if value does not exceed $3,600 cash value and veteran's annual income is not over $3,600. Exempt from all real property taxes.

[8] Veteran must have a 10 per cent or over disability. Exempt from all real and personal property taxes.

[9] For various Armed Forces service performed during and since World War II, a $500 exemption is extended on real and personal property. World War I veterans are extended a $750 exemption. Maximum exemption of $3,000 extended to veterans of Mexican War and War of Rebellion. Exempt from all real and personal property taxes.

[10] Veterans' Homestead tax exempt, 1947 to 1964. Homestead area limited to 160 acres. Exempt from State, Parish, and special property taxes.

TABLE I (*Continued*)

States	Amount of Exemption Extended to Eligible Veterans	Amount of Exemption Extended to Disabled Veterans	Legal Authority for Exemption	Recent Revisions in Legal Authority	Property Tax Levies Included in the Exemption
Maine [11]	.....	$3,500 [a]	Sec. 10, ch. 91-A, R.S.	1944, 1947, 1951, 1953	All
Maryland [12]	.....	The Homestead	Sec. 8(35), art. 81, code	1950, 1951, 1952, 1953	All
Massachusetts [13] ..	.....	$2,000 to $8,000 [a]	Sec. 5, ch. 59, G.L.	1933, 1943, 1945, 1951, 1954, 1955, 1956	All
Michigan [14]	$2,000 [a]	.....	Sec. 7.7, C.L.	1948, 1949, 1955	All
Nevada [15]	$1,000	.....	Sec. 1, ch. 344, Laws, 1953	1929, 1949, 1951, 1953, 1955	All
New Hampshire [16]	$1,000 [a]	$5,000 [a, b]	R.S. 72-28, 72-35	1942, 1947, 1949, 1951, 1955	All
New Jersey [17]	$500 [a]	The Homestead [b]	Sec. 54:4-3, 12, R.S.	1940, 1949, 1951, 1952, 1953	All
New Mexico [18] ...	$2,000 [a]	.....	Sec. 72-1-13, ch. 72, art. I, N.M. Stat.	1947, 1951, 1953	All
New York [19]	$5,000 [a]	$10,000 [b]	Sec. 4, tax law, ch. 60, C.L.	1949, 1950, 1951, 1953	State, County, Municipal
North Dakota [20] ..	.....	$10,000	Laws, 1955, ch. 315	....	All
Oklahoma [21]	$200 [a]	.....	Sec. 15.2, tit. 68, O.S.	1947	All

[a] If the veteran is deceased the tax exemption is usually extended to the eligible unmarried widow and minor children. In certain states, this exemption can be extended to the veteran's father or widowed mother.

[b] Amount of disabled veterans' tax exemption is in lieu of tax exemption granted to non-disabled veterans.

[11] Also extended to aged and indigent persons' estate. Exempt from all real and personal property taxes.

[12] Extended only to veterans with service-connected disability which precludes locomotion. Homestead limited to dwelling house and lot. Exempt from all real property taxes.

[13] The minimum exemption extended on real estate is $2,000. The maximum extended is $8,000. Eligibility depends on the percentage of disability and war service. Exempt from all real property taxes.

[14] The exemption extended to real estate only if the taxable value of real and personal property does not exceed $7,500. Exempt from all real property taxes.

[15] Extended to any veteran who served at least 90 days during World War I and II and Korean conflict and is a resident of state. Exempt from all real property taxes.

[16] The $1,000 exemption extended to residential real estate where the assessed value of such property does not exceed $5,000. Exempt from all real property taxes. The $5,000 exemption extended to real and personal property of totally disabled veterans. Exempt from all real and personal property taxes.

[17] The $500 exemption includes real and personal property. Exempt from all property tax levies. Homestead exemption includes real property of disabled veterans. Exempt from real property tax levies.

[18] Exemption includes real and personal property. Exempt from all real and personal property taxes.

[19] The $5,000 exemption extended on real estate purchased by the veteran with pensions, bonuses, and funds of similar nature from the Federal Government. The $10,000 exemption extended on real estate purchased with voluntary assistance money. Exemption does not cover school taxes. Exempt from state, county, and municipal real property taxes.

[20] Extended on specially adapted homesteads of disabled veterans. Exempt from all real property taxes.

[21] Extended to personal property only. Exempt from all personal property taxes.

TABLE I (*Continued*)

States	Amount of Exemption Extended to Eligible Veterans	Amount of Exemption Extended to Disabled Veterans	Legal Authority for Exemption	Recent Revisions in Legal Authority	Property Tax Levies Included in the Exemption
Oregon [22]	.....	The Homestead [a]	O.R.S. 307.250	1940, 1949, 1951, 1953, 1955,	All
Rhode Island [23] ..	$1,000 [a]	$2,000 [b]	Gen. Laws, 1938, ch. 29, Sec. 6	1938, 1944, 1947, 1949	All
South Carolina [24] .	.....	The Homestead	Sec. 65-1522(10), tit. 65, ch. 16, S.C.C. 1952	1952	State, County, Municipal
Tennessee [25]	.....	$10,000	Sec. 67-509, T.C.A.	1951	All
Utah [26]	.....	$3,000 [a]	Sec. 59-2-5, U.C.A.	1947, 1948	All
Vermont [27]	.....	$2,000 [a]	Sec. 648, ch. 37, tit. 8, V.S. 1947	1947, 1949, 1951	All
Wyoming [28]	$800	$ 800 to $2,000	Sec. 32-102, W.C.S.	1949, 1951, 1953, 1955	All

[a] If the veteran is deceased the tax exemption is usually extended to the eligible unmarried widow and minor children. In certain states, this exemption can be extended to the veteran's father or widowed mother.

[b] Amount of disabled veterans' tax exemption is in lieu of tax exemption granted to nondisabled veterans.

[22] The exemption extended only where the total value of all the veteran's property does not exceed $7,500. Veteran must possess a 40 per cent or more disability and his annual income cannot be more than $2,500 during last calendar year. Exempt from all real and personal property taxes.

[23] The $2,000 exemption extended only to totally disabled veterans of World War I or II. Exempt from all real and personal property taxes.

[24] This exemption extended to homes of paraplegics acquired under Federal laws. This property tax exemption includes the disabled veteran's automobile. Exempt from state, county, and municipal real property taxes.

[25] Extended to a disabled veteran's real estate occupied as a home. Exempt from all real property taxes.

[26] The veteran's percentage of disability applied to $3,000 determines the amount of tax exemption. For a 100 per cent disability rating, the full exemption of $3,000 is allowed. This exemption covers tangible real and personal property. Exempt from all real and personal property taxes.

[27] Extended to World War I and II veterans with a 50 per cent or more disability rating. Exemption applicable to real and personal property. Exempt from all real and personal property taxes.

[28] Aggregate tax benefit to any one nondisabled claimant is limited to $800. Disabled veterans, after receiving the above tax benefit, are further exempt in proportion to their disability, up to a limit of $2,000. Exempt from all real and personal property taxes.

against property owners but ordinarily, they are not considered property taxes. Veterans are not exempt from these special assessments.

The maximum exemption granted to eligible nondisabled veterans is limited in most states to $1,000 or $2,000. Two states—New York and Louisiana—exempt real property up to a maximum of $5,000. At the other extreme, New Jersey limits the amount of the exemption to the first $500 of the assessed value of real and personal property. Iowa sets the same maximum for veterans of service during and since World War II, and in Oklahoma, where the exemption applies to personal property only, the limit is $200. For dis-

abled veterans, the amount of exemption ranges from up to $10,000 in New York, North Dakota and Tennessee, to the value of the homestead, without limit, in six other states.

In terms of actual market value, the amount of the exemption granted will usually cover the assessed value of the exempt property, as property is commonly assessed well below its true value. For example, a house and lot actually worth $10,000 might well be assessed at a value of only $4,000 for taxation. A veterans' exemption of $2,000, as found in Arizona, Michigan, and New Mexico, would reduce the tax bill on this property by half,[2] and in New York or Louisiana, the property would be completely exempt from taxation.

Resume of Legal Provisions

The various state Constitutions and legal codes are explicit in the criteria for eligibility. In general, to qualify for a veterans' tax exemption, a person must (a) have served on active duty with the United States Armed Forces during a period of national emergency; (b) have been honorably discharged, and (c) be a resident of the state. As noted, some states limit the exemption to veterans with service-connected disabilities.

In many of the states, eligibility for this exemption is narrowly defined. For example, to be eligible, a veteran in Nevada must have been a member of the Armed Forces during one of the following periods—April 6, 1917, to July 2, 1921; or December 8, 1941, to December 31, 1946; or June 1, 1950, to February 1, 1955. Michigan, New Mexico, and Wyoming have a similar requirement, but the dates differ slightly.[3]

In all 28 states, the veteran is eligible for this exemption only if he is a resident of the state. In Maine, the veteran must have been a resident at the time of entry into military service or for 10 years prior to initiating claim for property tax exemption. Several states require a veteran to have established state residence prior to a cutoff date. For example, in Arizona, veterans of World War II must have been state residents prior to September 1, 1945; World War I veterans must have been residents before January 1, 1927. Nevada requires that the veteran be a state resident for 3 years before he files for a property tax exemption. In New Mexico, veterans of the following wars must have been state residents before the following years: World War I veterans before 1934; World War II veterans before 1947; and Korean War veterans before 1955.

All the states require the veteran to file an application for this property tax exemption. The majority require an annual application to be made with the local tax officials. However, in New York, once the tax assessor has determined that the veterans' property is exempt, his decision stands until the status of the property changes. Similarly, in Iowa, a veteran who has once filed and is qualified is not required to file each year to retain tax-exemption status.

2 This assumes the tax rate to be unaffected by the reduction in the tax base.

3 These periods of service should not be construed to imply that only the veterans of the most recent wars are eligible for property tax exemptions. Several states have granted a property tax exemption to veterans since before the turn of the century.

TABLE II

THE ASSESSED VALUE OF VETERANS' TAX EXEMPT PROPERTY, AVERAGE TAX RATE, AND THE ESTIMATED TAX SAVING IN SELECTED STATES FOR SELECTED YEARS

Year	Amount of Veterans' Exemption	Average Tax Rate	Tax Saving
	$1,000	*Dollars*	*$1,000*
Arizona [1]			
1936	[4]	4.39	.....
1941	6,013	3.80	228
1946	6,203	3.20	199
1951	24,269	5.06	1,228
1956	39,701	6.17	2,450
California [1]			
1936	85,584	[5]	.....
1941	120,891	4.18	5,053
1946	194,849	4.31	8,398
1951	584,240	5.74	33,535
1956	879,473	6.18	54,351
Connecticut [1, 2]			
1936	28,264	2.32	656
1941	33,497	2.39	801
1946	67,608	2.49	1,683
1951	160,709	3.03	4,869
1956	[6]	[6]	.....
Indiana [3]			
1936	3,112	2.62	82
1941	5,657	2.66	150
1946	9,466	3.09	292
1951	44,218	3.85	1,702
1956	[6]	[6]	.....
Iowa [3]			
1936	36,051	3.11	1,121
1941	41,629	3.34	1,390
1946	51,669	3.95	2,041
1951	89,633	4.90	4,392
1956	[6]	[6]	.....
New Hampshire [1]			
1936	5,223	3.43	179
1941	5,895	3.35	197
1946	8,498	3.47	295
1951	24,266	4.35	1,056
1956	[6]	[6]	.....
New Jersey [1]			
1936	20,042	4.153	832
1941	24,129	4.818	1,163
1946	37,293	5.110	1,906
1951	99,466	6.441	6,407
1956	160,308	7.888	12,645
New Mexico [1]			
1936	9,584	2.5807	247
1941	10,229	2.4843	254
1946	11,026	2.2615	249
1951	36,783	2.5674	944
1956	[6]	[6]	.....
Oregon [3]			
1936	[7]	4.33	[7]
1941	3,717	2.64	98
1946	3,833	4.68	179
1951	7,617	6.24	475
1956	15,960	7.76	1,238
Wyoming [1]			
1936	9,057	2.406	218
1941	9,794	2.553	250
1946	12,759	2.755	352
1951	21,161	3.497	740
1956	17,157	3.817	655

[1] Average property tax rate published in the State reports.

[2] Amount of veterans' tax exemption includes blind exemptions.

[3] Average property tax rate computed; see footnote 5 in the text.

[4] The amount of the veterans' property tax exemption was not classified separately from the total value of all tax-exempt property.

[5] Average tax rate not available.

[6] Data for the most recent years unpublished to date.

[7] Veterans' property tax exemption first granted in 1941.

Source:

- Biennial Reports of the Arizona State Tax Commission.
- Annual Reports of the California State Board of Equalization.
- Information Relative to Assessment and Taxes in Connecticut.
- Annual Reports of the Iowa State Tax Commission.
- Annual Reports of the State Auditor of Indiana.
- The Yearbook of Indiana.
- Annual Reports of New Hampshire State Tax Commission.
- Annual Reports of the New Jersey Division of Taxation.
- Biennial Reports of the New Mexico State Tax Commission.
- Biennial Reports of the Oregon State Tax Commission.
- Biennial Reports of the Wyoming State Board of Equalization.

Fiscal Significance of Veterans' Property Tax Exemptions

In the last 10 years, both the number and the amount of veterans' tax exemptions have increased. From 1946 to 1956, the assessed value of veterans' exempt property increased 15.6 per cent in Arizona; 22.2 per cent in California; 23.3 per cent in New Jersey; and 24.0 per cent in Oregon. A similar trend has also occurred in the other states shown in Table II.

Published data indicative of the increase in the number of veterans granted a property tax exemption are available in only two states—Arizona and Iowa. The number of veterans granted an exemption in Arizona increased from 25,-205 in 1950 to 42,810 in 1956. In Iowa, the number of veterans increased from 150,674 in 1950 to 186,732 in 1955.

There are three reasons for these increases in the number of veterans and the amount of assessed value that is tax exempt. First, the various states have enacted or expanded the coverage of this tax exemption at periods when an especially large number of veterans were eligible; second, the value of real estate has increased generally since 1946, and this rise is reflected on the tax rolls; [4] third, population shifts and growth have increased at a particularly rapid rate in several of the states that have liberal exemptions.

In Table II, the tax savings to veterans through property exemption are shown for ten states for which data are available.[5] As would be expected, the savings to veterans have increased each year. It is estimated that 42,810 eligible veterans in Arizona were released from property taxes of approximately $2.4 million in 1956. In 1955, the 186,732 eligible veterans in Iowa were released from an estimated tax bill of $5.8 million. In several of the other states, significant amounts of tax savings occurred in 1956—California, $54.4 million; New Jersey, $12.6 million; Oregon, $1.2 million; and Wyoming $0.7 million. Data for 1956 are not available for Connecticut and Indiana but it is estimated that in 1954 veterans were released from property taxes of approximately $6.3 million, and $2.5 million, respectively. Further, it is estimated that the tax saving for 1953 for New Hampshire was $1.2 million and $1.5 million in New Mexico for 1955.

The aggregate tax loss because of this exemption appears to be small when compared with the total amount of property taxes levied during a tax year in any one state. Assuming a constant amount of revenue to be collected, removal of the exemption would reduce the tax bill on nonexempt properties by not more than several per cent. For example, in Arizona, if there had been no veterans' property tax exemption the $76 million tax bill on nonexempt property would have been reduced by 2.6 per cent, or $2 million. At the same time, the tax bill on veterans' property would have increased by an equivalent amount. Under the same

[4] However, in 6 states—Arizona, California, Idaho, Michigan, New Hampshire and Oregon—where only veterans owning less than a certain value of property are eligible, a rise in assessed values would disqualify some veterans.

[5] The estimate of tax savings in each state was derived by the following procedure. An average annual tax rate was applied to the assessed value of veterans' property tax exemptions. This average tax rate was obtained in the following manner. Several state tax reports published an average tax rate. In other states the total taxable value of all property, not including the value of exempt properties, was divided into the aggregate amount of property taxes levied to derive an average tax rate for that year.

assumptions, the 1956: tax bill on nonexempt property would be reduced 4.4 per cent in California; 2.2 per cent in New Jersey; 0.7 per cent in Oregon; and 2.3 per cent in Wyoming. It would have been reduced in 1954: 2.9 per cent in Connecticut; 1.0 per cent in Indiana; and 4.5 per cent in New Mexico. Further, in Iowa during 1955 and New Hampshire during 1953, the tax bill would be reduced 2.3 and 2.6 per cent, respectively.[6]

The significance of this tax exemption, however, does not lie solely in the aggregate amount of taxes from which veterans are released or in the increase in property tax collections had there been no exemption. The greater significance of this state tax program lies in its fiscal effects on local governments.

As noted earlier, veterans' property tax exemptions affect mainly the local governments. Many of the 28 states that grant this tax exemption have abandoned the property tax for state revenue purposes, and in those states that have not done so, the amount collected is usually very small in proportion to revenue collected from other sources. Virtually all state governments have shifted from the property tax to income, excise, sales, and use taxes as the most consistent revenue producers. But the property tax is still the primary source of revenue for local governments.

When the state grants a tax exemption to eligible veterans from all property taxes, the tax base of local governments is reduced. The tax-base reduction will not be uniform. It will vary among the government tax jurisdictions. Data indicative of the reduction in the property tax base of local governments is contained in the Annual Report of the New Jersey Division of Taxation for 1956. The percentage of the assessed value of real and personal property that is tax exempt as veterans' and widows of veterans' property in 21 counties ranges from a low of 1.1 per cent in Essex County to 7.4 per cent in Hudson County. Moreover, when the taxing districts within counties are examined, the percentages vary even more. For example, in the 37 taxing districts in Camden County, 12 tax districts have zero to 3.3 per cent of the real and personal property tax base exempt; 7 have 4.0 to 4.7 per cent; 16 have 5.0 to 8.9 per cent; and 2 have 9.0 and 9.4 per cent.[7]

To compensate for this decrease in the tax base, local governments usually are forced to increase tax rates. For example, in its 1949 report, the New Hampshire Tax commission states that as a consequence of the veterans' property tax exemption, the average tax rate was $4.31. Assuming a constant total amount of revenue to be collected, the rate would have been $4.19 if there had been no tax exemption.[8] The effect of the rate increase is to shift the burden of local property taxation more heavily on the owners of nonexempt property.

Reimbursement to Local Governments

Several of the 28 states that grant a veterans' property tax exemption reimburse their local governments specifically to compensate for the amount of taxes foregone. In Maine, any municipality that extends a veterans' property tax exemption is entitled to recover 70 per cent of any tax loss that exceeds 3 per

[6] Computed from state tax reports and Table II.

[7] Computed from the Annual Report of the Division of Taxation in the Department of the Treasury for the year 1956, pp. 106-205.

[8] Thirty-Ninth Annual Report of the New Hampshire State Tax Commission, p. 9.

cent of the local tax levy. Iowa allocates 5 per cent of the gross receipts from liquor store sales to a fund administered by the state for the purpose of reimbursing local governments for property tax revenue foregone. The maximum reimbursement to any local government is fixed at 25 mills on the dollar of assessed valuation of the tax-exempt property. The State of Louisiana has a Property Tax Relief Fund from which a fixed percentage of the revenue from the alcoholic beverage tax, the state income tax, and the public utilities taxes are earmarked as reimbursements to local governments.

Conclusion

Veterans' property tax exemptions appear to be of minor significance when one looks only at the amount of revenue involved. The tax saving to individual veterans may be sizable, but as a proportion of total property tax collections, the revenue loss is small. Moreover, a fixed amount of tax exemption tends to diminish in significance as the value of property and the average rate of assessments rise, as they have done in recent years.

On the other hand, the amounts of veterans' tax exemption have shown a persistent tendency to increase. Veterans' tax exemptions have proved to be a popular means of expressing the debt of gratitude that society feels toward returning veterans. The cost to the public at large is small and widely diffused, in contrast to the direct and obvious gain to those who qualify. In any event, the number of states that offer property tax exemption to veterans has tended to increase, and in states that have such exemptions their scope has tended to grow.

Veterans' exemptions also have an impact on local government finances, but the effect is uneven. In states that reimburse local subdivisions for a substantial part of the revenue loss, the effect may be infinitesimal. This is true also of units that have little property removed from the tax rolls by virtue of the exemption. Other units, however, experience a greater loss of revenue; they may be forced to increase tax rates, seek some other source of revenue, or curtail services.

The growing importance of veterans' property tax exemptions has implications also for the role of the property tax in state and local finance. The removal of property from the scope of local taxation undermines the revenue potential of the property tax, thereby contributing to its decline. Conversely, the reduced importance of property taxation and the increasing reliance by local governments on other sources of revenue diverts attention from the necessity of preserving the property tax base. Thus, the rise in veterans' exemptions is to some extent both a cause and a result of the well-defined trend toward less dependence by state and local governments on ad valorem taxation.

THE COUNTER-CYCLICAL FISCAL ROLE OF STATE GOVERNMENTS DURING THE 'THIRTIES

ANSEL M. SHARP *

Introduction

IT HAS been generally accepted that states pursue fiscal activities that tend to aggravate economic fluctuations; hence, the reasoning continues, federal fiscal policy has to compensate for changes in both private spending and state and local spending in order to stabilize income and employment at high employment levels without inflation. In support of this reasoning, co-authors George W. Mitchell, Oscar F. Litterer, and Evsey D. Domar state:

> The financial practices of these governments (state and local) have tended to aggravate rather than alleviate cyclical swings in business and employment, and the mildly counter-cyclical fiscal policy of the Federal Government has been in considerable measure offset by state and local financial management.[1]

Alvin H. Hansen, Harvey S. Perloff and Mable Newcomer agree. Hansen and Perloff have said, " States and localities have in fact followed the swings of the cycle and have thereby intensified the violence of economic fluctuations." [2] Newcomer writes, " The record of the past thirty years shows that state and local finances have tended to follow the trend of private business activity." [3]

It is the purpose of this paper to question the validity of the general proposition that the fiscal activities of state governments aggravated cyclical fluctuations in the United States during the Great Depression and recovery of the 'thirties.

Of late, some attention has been given this question, and doubts have been expressed as to the applicability of this general proposition to the fiscal activities of state and local governments. The Federal Reserve Bank of New York finds that there has been only one period during which it might be said that state and local governments aggravated the cycle—the period of the 'thirties after 1931. In its recent *Monthly Review*, it was concluded:

> . . . . A comparison of state and local spending with revenues for the period since 1929 indicates that the budgetary position of state and local governments has moved counter cyclically . . . with the exception of the depression years after 1931. During recessions, expenditures have advanced more rapidly than revenues—so that states and localities were adding more to the aggregate demand than they were withdrawing

* The author is Assistant Professor of Economics at Oklahoma State University.

[1] George W. Mitchell, Oscar F. Litterer, and Evsey D. Domar, *Public Finance and Full Employment, Postwar Economic Studies, No. 3,* (Washington: Board of Governors of the Federal Reserve System, December, 1945), p. 123.

[2] Alvin H. Hansen and Harvey S. Perloff, *State and Local Finance in the National Economy* (New York: W. W. Norton and Company, 1944), p. 199.

[3] Mabel Newcomer, " State and Local Financing in Relation to Economic Fluctuations," *National Tax Journal,* Vol. VII, No. 2, June, 1954, p. 97.

through taxation—while the reverse has been the case (although not so regularly) during periods of prosperity. . . .[4]

As is usually the case, state and local governments are analyzed together, with little or no attention being given to the role of the state government alone. When the data are separated, it appears that there is nothing in the data on state and local expenditures to give support to the thesis that state spending was following the swings of the cycle, and there is some doubt whether the thesis applies completely to combined state and local spending during the 'thirties.

Social and fiscal responsibilities were thrust upon state governments, just as they were upon the federal government, during the severest depression in our history. These fiscal responsibilities were not completely accepted by state governments; neither were they completely accepted by the federal government. The spending and tax policies pursued by state governments were a response to economic conditions rather than a conscious attempt to improve economic conditions. This statement applies to the spending and tax policies of the federal government during most of the 'thirties.[5] It would appear then that both federal and state governments reacted to the depression in much the same way and for the same reasons. Could state financial management then have been so far removed from federal financial management that it offset any good that federal policies might have brought about?

This paper is organized to examine state and local spending, state and local revenues which financed this spending, and the over-all economic effect of these fiscal activities during the period, 1929–1938.

State and Local Spending

Counter-cyclical fiscal policy dictates that government spending should be increased during contractionary periods and decreased during expansionary periods. Table I reveals that state spending showed an upward trend throughout the 'thirties. On the other hand, total state and local spending acted perversely —decreasing during the contraction and increasing during the expansion of the 'thirties. However, this perversity must be attributed to local spending not to state spending.

In all fairness to local spending, it is interesting to note that in 1929 prices, total state and local spending did not intensify the cycle. To the extent that measuring state and local spending in constant 1929 prices is an indication of the change in the volume of these expenditures, it may be stated that total state and local expenditures were buying more goods and services in 1932 than they had been at the beginning of the depression. In constant 1929 prices, total state and local spending reached its highest level when economic activity was at one of its lowest ebbs, and decreased or stayed about the same when the recovery forces started. Where then are the data which prove that state spending followed the swings of the cycle? [6]

[4] *The Monthly Review,* Federal Reserve Bank of New York, June, 1957, p. 78.

[5] It is generally accepted that federal fiscal policy during the 'thirties was not a systematic anti-cyclical policy. See Arthur Smithies' "Federal Budgeting and Fiscal Policy," *A Survey of Contemporary Economics,* ed., Howard S. Ellis, p. 175.

[6] A very important *type* of state and local expenditure, construction expenditures, did follow the downward forces between 1929–1933 and continued to stay at a low level during the recovery of the 'thirties. This decline in state and local construc-

(See next page)

Financing State and Local Spending

Counter cyclical fiscal policy also calls for a smaller proportion of government spending to be financed from tax revenues during contractionary periods, and a larger proportion to be financed from tax revenues during expansionary periods.

TABLE I

State and Local Spending in Selected Fiscal Years, 1930–1938[1]

	Current Prices ($ millions)	Adjusted 1929 Prices ($ millions)	Per Cent of Private Spending
1930			
Total[2] ...	$9,092	$10,046	11.2%
State	2,290	2,530	2.8
Local	7,200	7,956	8.9
1932			
Total[2] ...	8,403	12,467	16.8
State	2,829	4,197	5.6
Local	6,375	9,458	12.7
1934			
Total[2] ...	7,842	9,964	14.3
State	3,461	4,398	6.3
Local	5,699	7,241	10.4
1936			
Total[2] ...	8,501	10,025	12.0
State	3,862	4,554	5.5
Local	6,056	7,142	8.5
1938			
Total	9,988	12,092	14.1
State	4,598	5,567	6.5
Local	6,906	8,361	9.8

Sources: United States Department of Commerce, Bureau of Census, *Financial Statistics of States* (state data for 1930), *Historical Statistics on State and Local Government Finances, 1902–1953* (data for 1932, 1934, 1936, and 1938), *A Supplement to the Survey of Current Business,* National Income Edition, 1951; Board of Governors of the Federal Reserve System, *Postwar Economic Studies No. 3,* December, 1945 (local data for 1930).

[1] Data for only even years are presented because the most reliable data for both state and local expenditures are available only in even years starting in 1932.

[2] Total state and local expenditures is exclusive of intergovernmental transfer so as to avoid double counting.

Table II reveals that state fiscal policy followed this pattern—state tax revenues decreased as a percentage of state spending during the contraction of the early 'thirties and increased during the recovery. State tax revenues did increase during the entire period, but state spending increased faster until after the recovery was under way. On the other hand, local tax revenues fell between 1930 and 1934; however, local spending fell approximately the same. The ratio of total state and local tax revenues to total state and local spending stayed approximately the same throughout the period, obscuring the fact that state spending was increasing relative to state tax revenues during the worst part of the depression.

States financed their excess of spending over tax revenues from non-tax sources (primarily liquor store revenues, and insurance trust revenues), revenue from other governments (primarily revenue from federal government), and borrowing. State revenues from their own non-tax sources financed approximately the same proportion of their spending throughout the period between 1930–1936. The significant growth in state non-tax revenues in 1938 reflects the participation of states in the social insurance program.[7] State revenues from other governments financed an increasing proportion of state spending until 1936, which reflects the growth of federal grants to state governments between 1930 and 1934 and the decline in

tion expenditures is especially accentuated if federal grants are deducted. See James A. Maxwell, *Federal Grants and the Business Cycle* (New York: National Bureau of Economic Research, Inc., 1952), p. 21.

[7] The Social Security Act of 1935 assured that states would establish a system of unemployment insurance by a crediting device. Each employer in a state was given a credit of 90 per cent of the federal payroll tax that could be applied against state payroll taxes. Since the federal payroll tax was 3 per cent, a state willing to participate in the program could levy a 2.7 per cent payroll tax without increasing the payroll tax burden in that state.

federal grants between 1934 and 1938.[8]

Federal Grants To States and State Payments to Local Governments

The economic and social conditions of the 'thirties imposed upon both the federal government and state governments new fiscal responsibilities and increased the interrelatedness of the three tiers of governments. State governments took over functions which previously had been local, increased state payments to local governments, and added new functions. The federal government attempted to pick up the pieces of a ruined economy by giving relief to people, farmers, banks, and states.[9] If hindsight tells us that the federal program came too late, and even then was a salvaging job rather than an all out planned venture, it does not deny the fact that attempts were being made whether by accident or design. Likewise it cannot be denied that attempts were made on the state level.

Table III points out that state spending rose throughout this period because of federal grants to state governments and state payments to local governments.

When federal grants are excluded from state spending, the growth of state spending was less, and between 1932 and 1934 state spending would have decreased from its 1932 level. Federal grants were playing a counter-cyclical role and were important in keeping up the level of state spending after 1932. However, during most of the Great Depression, state spending was rising exclusive of federal grants.

During the 'thirties, state payments to local governments became a vital part of the spending structure of state governments and of the revenue structure of local governments. Similar to federal grants to states, state payments to local governments played a counter-cyclical role by relieving the local revenue system of the almost impossible burden of financing many of their important services.

Net Effect of State and Local Fiscal Policy

The crucial counter-cyclical fiscal policy test is for the net effect of government fiscal activity to add to the flow of income during contractionary periods and to subtract from the flow of income during expansionary periods. This would, of course, tend to smooth out cyclical fluctuations.

One way of indicating the effect of state and local fiscal policy is through changes in outstanding debt.[10] Increases in debt indicate net additions to the flow in income and decreases indicate net subtractions.[11]

[8] Available data showing state revenue from the federal government in even years reveal that this source of state revenue rose rapidly between 1932 and 1934, reaching a peak for the 'thirties of $968 million. In 1938, state revenue from the federal government had declined to $633 million. U. S. Bureau of Census, Department of Commerce, *Historical Statistics on State and Local Government Finances, 1902–1953*, p. 19.

[9] Gerhard Colm, "Fiscal Policy and the Federal Budget" in *Income Stabilization for a Developing Democracy*, Edited by Max F. Millikan. (New Haven: Yale University Press, 1953.) p. 215; Alvin Hansen, *Fiscal Policy and Business Cycles* (New York: W. W. Norton and Co., Inc., 1941), pp. 84–95.

[10] Henry H. Villard, *Deficit Spending and the National Income* (New York: Farrar and Rinehart, Inc., 1941), p. 288.

[11] It is assumed that an increase in state and local debt indicates the part of state and local spending financed from savings or money created by the banking system, and decreases in the debt of these governments measures the revenues which have not been used to buy current produced goods and services. In determining the net effect of government fiscal policy, it is important to have some measure

(See next page)

State governments added to their outstanding debt every year during the 1930–1933 depression. It was not until after 1935, when the economy was recovering and when men in authority were becoming restless about rising prices,[12] that state debt started to decline. Local governments, even though

TABLE II

STATE AND LOCAL REVENUES IN SELECTED FISCAL YEARS, 1930–1938

	Total Revenues[1] ($ millions)	Tax Revenues		Non-Tax Revenues[2]		Revenues from Other Governments[3]	
		Total	Per Cent of Total Spending	Total	Per Cent of Total Spending	Total	Per Cent of Total Spending
1930							
Total[8]	$ 8,045	$6,798	74.8%	n.a.[9]	n.a.	n.a.	n.a.
State	2,243	1,780	77.7	$ 343	15.0%	$ 120	5.3%
Local	6,200	5,018	69.7	n.a.	n.a.	n.a.	n.a.
1932							
Total	7,887[4]	6,164	73.4	1,490	17.7	232[5]	2.8
State	2,541	1,890	66.8	384	13.6	267[6]	9.4
Local	6,192	4,274	67.0	1,107	17.4	811[7]	12.7
1934							
Total	8,465[4]	5,912	75.4	1,502	19.2	1,051[5]	13.4
State	3,465	1,979	57.2	473	13.7	1,004[6]	29.0
Local	6,363	3,933	69.0	1,029	18.1	1,401[7]	24.6
1936							
Total	9,469[4]	6,701	78.8	1,711	20.1	1,056[5]	11.2
State	4,132	2,618	67.8	647	16.8	867[6]	22.4
Local	6,793	4,083	67.4	1,064	17.6	1,646[7]	27.2
1938							
Total	11,058[4]	7,605	76.1	2,653	24.0	800[5]	8.0
State	5,293	3,132	68.1	1,480	32.2	681[6]	14.8
Local	7,329	4,473	64.8	1,173	17.0	1,683[7]	24.4

Sources: United States Department of Commerce, Bureau of Census, *Financial Statistics of States* (State data for 1930), *Historical Statistics on State and Local Government Finances, 1902–1953* (data for 1932, 1934, 1936, and 1938); Board of Governors of the Federal Reserve System, *Postwar Economic Studies No. 3,* December, 1945 (local data for 1930).

[1] Total revenues includes revenues from own sources (exclusive of borrowing) and revenue from other governments.

[2] Non-Tax revenues includes changes and miscellaneous liquor store revenues and insurance trust revenue.

[3] Revenues from other governments includes federal aid to state and local governments, state payments to local governments, and local payments to states.

[4] State payments to local governments and local payments to state governments are excluded to avoid duplication.

[5] Includes only federal grants to state and local governments to avoid duplication.

[6] Includes federal grants to states and local payments to states.

[7] Includes federal grants to local governments and state payments to local governments.

[8] In 1930, data on intergovernmental transfers are unavailable in some instances and incomplete in others. State aid to local governments for the purposes of education and highways is available and has been deducted from total state and local revenues to avoid as much duplication as possible.

[9] Data unavailable.

of government spending which has been financed from idle funds, i.e., funds that would not have been spent on current output anyway. For, government spending financed out of private funds which would have been used for either private consumption and/or investment does not indicate net contribution to the flow of income. Alvin Hansen, *Fiscal Policy and Business Cycles*, p. 90.

[12] The fear of inflation by fiscal and monetary authorities culminated in the drastic drop in federal net spending in 1937 and the doubling of reserve requirements between August 15, 1936 and May 1, 1937.

encountering serious difficulties in borrowing,[13] managed to add to their outstanding debt during the 1930–1933 period. Only in one year, the first year of the recovery (1934) did local debt decline significantly.

This should not be surprising. Depressionary forces do not reduce the demand for state and local services. If anything, the demand for these services (especially in real terms) is increased. Yet, depressionary forces reduce the base on which state and local taxes are levied. These governments are forced into deficit financing whether they like it or not.

The important thing, however, is that the debt activities of state and local governments during the 'thirties do not generally support the argument that the financial practices of these governments intensified the cycle. If this had been the case, it would be expected that these governments would have decreased their debt in the early 'thirties and increased their debt during the latter 'thirties. The reverse was true for state governments, and only in one year did local governments act perversely and decrease debt outstanding.

Another way of indicating the net effect of state and local fiscal policy is to observe the difference between state and local spending and state and local revenues.[14] The assumption is that state and local spending adds to the flow of income, and state and local revenues subtract from the flow of income. Then, the net addition to the flow of income in a given year is measured by the excess of spending over revenues, and net subtractions are measured by the excess of revenues over spending. In Table VI below, plus net spending shows

TABLE III

State Spending Exclusive of Federal Grants and Exclusive of State Payments to Local Government in Selected Fiscal Years, 1929–1938
($ millions)

Year	Total State Spending	State Spending Exclusive of Federal Grants	State Spending Exclusive of State Payments to Local Government	State Spending Exclusive of Federal Grants and State Payments to Local Government
1929	$2,061	$1,942	$1,700[1]	$1,575
1930	2,290	2,177	1,892[1]	1,779
1931	2,509	2,314	2,090[1]	1,895
1932	2,829	2,607	2,028	1,806
1934	3,465	2,493	2,143	1,179
1936	3,862	3,034	2,445	1,617
1938	4,598	3,965	3,082	2,449

Source: United States Department of Commerce, Bureau of Census, *Financial Statistics of States* (data for 1929, 1930, and 1931), *Historical Statistics on State and Local Government Finances, 1902–1953* (data for 1932, 1934, 1936, and 1938); James A. Maxwell, *Federal Grants and the Business Cycle* (New York: National Bureau of Economic Research, Inc., 1952) (data on federal grants for 1929, 1930, and 1931).

[1] Only state payments to local governments for the purposes of highways and education segregated in those years.

[13] Harvey S. Perloff, "Fiscal Policy at the State and Local Levels," *Postwar Economic Problems*, edited by Seymour Harris, p. 225.

[14] This measure of the net effect of state and local fiscal policy is used in the study published by the Board of Governors of Federal Reserve System, *Postwar Economic Studies, No. 3*, December, 1945, *Public Finance and Full Employment*, p. 117.

the excess of spending over revenues, and minus net spending shows the excess of revenues over spending.

The difficulty which arises when measuring the net effect of state and local fiscal policy in this manner is deciding what spending to include and what revenues to include. A decision to include or exclude a particular type of spending and/or a particular type of revenue may significantly affect the figure derived for net spending. In this study, it was decided to include all spending with the exception of spending on debt repayment, and to include all revenues with the exception of revenues from borrowing.

TABLE IV

LOCAL SPENDING AND STATE PAYMENTS TO LOCAL GOVERNMENTS IN SELECTED FISCAL YEARS, 1930–1938

($ millions)

Year	Local Spending	Local Spending Exclusive of State Payments to Local Government	State Payments to Local Governments
1930	$7,200	$6,802	$ 398[1]
1932	6,375	6,574	801
1934	5,699	4,381	1,318
1936	6,056	4,639	1,417
1938	6,906	5,390	1,516

Source: United States Department of Commerce, Bureau of Census, *Financial Statistics of States* (data on state payments to local governments for 1930), *Historical Statistics on State and Local Government Finances, 1902–1953* (data for 1932, 1934, 1936, and 1938); Board of Governors of the Federal Reserve System, *Postwar Economic Studies No. 3*, December, 1945 (local data for 1930).

[1] State payments to local governments segregated only for the purposes of education and highways in this year.

Table VI reveals that state net spending was positive and rising throughout the 1929–1932 depression, and local net spending was positive but declining. Both levels of government weathered the first two years of depression fairly well. If appropriate fiscal action had been taken by the federal government during this period, it is likely that state and local governments would have withstood the entire depressionary period better than they did. As it was, local governments drastically reduced spending in face of falling tax revenues after 1931. State governments did much better. State spending increased in the face of declining economic activity. However, states did adopt new taxes and did increase rates on old deflationary taxes in order to finance part of the increase in spending.[15] The federal government did likewise; that is, when federal spending started increasing rapidly in 1933, a part of it was financed from increasing federal deflationary taxes.[16]

TABLE V

STATE AND LOCAL CHANGES IN GROSS DEBT OUTSTANDING DURING FISCAL YEARS, 1930–1938.

($ millions)

Year	State	Local
1930	$ + 144	$ + 1,081
1931	+ 200	+ 853
1932	+ 223	+ 9
1933	122	+ 59
1934	+ 167	− 826
1935	+ 130	+ 13
1936	− 9	+ 306
1937	− 42	− 26
1938	− 32	+ 6

Sources: United States Department of Commerce, Bureau of Foreign and Domestic Commerce, *Economic Series No. 21*, Indebtedness in the United States, 1929–1941 (data for 1929, 1931, 1933, 1935, and 1937); *Historical Statistics on State and Local Government Finances, 1902–1953* (data for 1932, 1934, 1936 and 1938).

[15] States increased tax rates during this period on such items as tobacco, gasoline, liquor, etc., and in 1933, a mass movement began in the adoption of a state general sales tax. W. J. Schultz and C. L. Harriss, *American Public Finance* (New York: Prentice-Hall, Inc., 1954), p. 364.

[16] The Federal Revenue Acts of 1932 and 1934 increased tax rates on personal and corporate income,

(See next page)

The net effect of state fiscal policy appears to have been a positive one. States contributed to the flow of income until after the recovery was well under way. The decline in state net spending after 1932 (observed in Table VI) partially reflects the rise in state tax revenues relative to state spending; it also reflects the rise in state revenue from the federal government.[17] If state spending financed from federal grants is included as a part of state net spending, state net spending would have increased impressively until after 1934, and would have remained positive until 1938.

It may be argued that state net spending was not of a sufficient magnitude to have had a noticeable counter-cyclical effect on the economy. This may be granted. The important fact, however, is that it seems that state fiscal policy did not intensify the cycle during the 'thirties.

TABLE VI

State and Local Spending, Revenues, and Net Spending in Selected Fiscal Years, 1929–1938

($ millions)

	1929	1930	1931	1932	1934	1936	1938
State Level							
Spending[1]	$2,061	$2,290	$2,509	$2,829	$3,461	$3,862	$4,598
Revenues[2]	2,058	2,243	2,324	2,541	3,456	4,132	5,293
Net Spending[3]	+ 2	+ 47	+ 185	+ 288	+ 5	– 270	– 695
Local Level							
Spending[1]	7,300	7,200	7,100	6,375	5,699	6,056	6,906
Revenues[2]	5,800	6,200	6,300	6,192	6,363	6,793	7,329
Net Spending[3]	+1,500	+1,000	+ 800	+ 173	– 664	– 737	– 423

Sources: U. S. Bureau of Census, Department of Commerce, *Financial Statistics of States* (State data for 1929, 1930, 1931); *Historical Statistics on State and Local Government Finances, 1902–1953* (state and local data for 1932, 1934, 1936, 1938); Board of Governors of the Federal Reserve System, *Postwar Economic Studies No. 3*, December, 1945, p. 115 (local data for 1929, 1930 and 1931).

[1] Includes all expenditures exclusive of debt retirement.

[2] Includes all revenue exclusive of borrowing.

[3] The excess of spending over revenue (+) and the excess of revenue over spending (–).

Conclusion

The conclusions of this paper are: the general proposition that state and local governments pursue fiscal policies which intensify the cycle may not be in complete conformity with their actual behavior. The general proposition that federal fiscal activity has offset both private spending and state and local spending may be highly questionable. State fiscal policy during the 'thirties meets certain counter-cyclical fiscal tests better than is generally realized.

estates, liquor, and tobacco, and extended federal taxes to gasoline and various manufactured products. *Annual Report of the Secretary of Treasury on the State of Finances*, 1940, pp. 7–12.

[17] Typically federal grants are deducted from state spending, which has the same effect on state net spending as the above approach in order to determine the net contribution of state fiscal policy. This would certainly be necessary in determining the combined contribution of federal, state, and local fiscal policy in order to avoid over-stating the total contribution of all three levels of government. However, when analyzing the net effect of fiscal policy at the state level, there may be reason for not doing this. Deducting federal grants from state spending either assumes that this spending does not add to the flow of income and/or state spending would have decreased by the amount of federal grants if these grants had not been forthcoming.

"TAX SPARING": A LEGEND FINALLY REACHES PRINT

JOSEPH P. CROCKETT *

ON JULY 1, 1957, an income tax convention between the United States and Pakistan was signed in Washington, and soon thereafter transmitted to the Senate for approval. The Foreign Relations Committee, to which it was referred, held public hearings on August 9, but decided to take no action at that Session although it reported out favorably an income tax convention with Austria and supplemental conventions with Canada and Japan. The proposed convention with Pakistan is the second to be concluded with a nation of Asia, and in nearly all respects reflects the general pattern of provisions which characterize existing conventions with 19 other countries.

The Committee's reluctance to take immediate favorable action resulted from criticisms directed exclusively against one feature of Article XV. By this article the United States agrees, as is customary and as sections 901-5 of the Internal Revenue Code provide, to grant its taxpayers credit against federal income tax in the amount of Pakistan income tax paid on income from sources within Pakistan. But in addition to this usual credit, it also agrees for the first time to treat as " paid," for purposes of credit, Pakistan income tax and super-tax which have been forgiven or " spared," under a law intended to attract new industries and stimulate the country's economic development.

* The author is a member of the District of Columbia bar.

For many years, and especially since the close of World War II, an increasing number of unindustrialized countries have used tax concessions as investment lure. The soaring tax rates of the post-war era should make this bait very tempting to a United States enterprise, and in Puerto Rico, the one area where it has operated under ideal laboratory conditions, the results appear to have fulfilled the most sanguine expectations. In other areas results have not been so impressive, and the reason is not far to seek. The United States is the primary fount of new capital and enterprise, and Puerto Rico is the only sizable area on earth from which a United States citizen or corporation can derive income free of federal tax. This exemption is made possible by the provisions of sections 931-933 of the Internal Revenue Code, and Puerto Rico has taken full advantage of them by an assortment of exemptions and concessions of its insular income tax. Today a formerly poor agricultural island is filled with factories and dollars that are the envy of its Latin American neighbors.[1]

[1] It is, of course, true that a stable government, a firm currency and duty-free access to the United States market have also been important contributing factors in causing continental participation in Puerto Rican development, and it has been argued by some that low taxes have not exerted any appreciable influence on corporate decisions to invest abroad. Human motives cannot be precisely isolated and appraised, of course, but the substantial sacrifices of revenue which the Government of Puerto Rico and many other governments are and have been making for years are convincing evidence that the leaders of those govern-

(See next page)

Mexico, Cuba, Colombia and other countries have enacted in various forms tax concessions comparable with those of Puerto Rico, insofar as their own taxation was involved, but without an equal measure of success in attracting capital from the United States. Their spokesmen plausibly complain that while they can and do make a sacrifice of their own revenue for stimulating development, they are not able to protect the American corporation from the United States Treasury, which under the existing tax code of this country automatically takes and keeps the rewards intended for the American corporation.

The operation of the foreign tax credit,[2] fully supports this charge. A corporation organized under the laws of the United States or of a state must report its profits from any source in the world, and pay on them a tax of 52 per cent (maximum). But after computing federal income tax on total profits, the corporation may credit against federal tax the amount of income tax, if any, paid to the foreign source country on its foreign income,—at least up to the amount of federal tax on that amount of income. Obviously a corporation which has been favored by a foreign tax exemption or reduction has no foreign tax or less foreign tax to credit, and pays just that much more federal tax as the net result of the foreign "benefit." Even if the U. S. corporation operates abroad through a foreign subsidiary, which is not subject to federal tax on foreign source income, it is still the loser, for it must pay tax on dividends received from the subsidiary, and under Sec. 902 could credit against federal tax the foreign tax *paid* on the profits from which the dividends were distributed. But there is no credit for foreign tax spared on the profits.

However meritorious the general application of the foreign tax credit may be, the federal tax system is not operating in a vacuum. It is part and parcel of a complex government, vitally concerned with economic, financial, defense and other policies in which foreign angles cannot be ignored, but on the contrary have received an increasing emphasis for two decades. Economic policy considerations, moreover, have influenced U. S. tax policy for many years and have repeatedly led to well warranted expansions or restrictions of general principles. Reference has already been made to the tax exemption applicable to income of Puerto Rican source. Similar, but not identical treatment, is accorded to income from Guam and other U. S. possessions, and the tax holidays of the Virgin Islands are making the headlines in the travel sections of Sunday supplements.

To stimulate United States enterprise in Latin America, the Western Hemisphere Trade Corporation was granted a privilege which amounts in effect to a tax rate of 38 per cent instead of the 52 per cent generally applicable.[3] A great benefit in the form of a special deduction was conferred on the China Trade Act Corporation to promote the development of Nationalist China.[4] And more recently (1951) the salary received for foreign services by a United States citizen who remains in a foreign

ments have faith in the incentive of low tax. The writer may add, moreover, that he has failed to detect in the American corporation any attitude of indifference to the amount of its tax assessments.

[2] Secs. 901-905. All section references are to the Internal Revenue Code of 1954.

[3] Secs. 921-2.

[4] Secs. 941-943.

country or countries for 510 days out of eighteen continuous months was exempted from income tax,[5] thus facilitating the employment of American executives and technicians abroad. As stimuli to American participation in enterprise and development outside the United States, these concessions promote a very major phase of our national foreign policy: the strengthening of the free world by building up the economies of its lesser developed nations.

As it well known, billions of United States tax dollars have been devoted to the support of this policy, but it has not been free from attack in some quarters. Among the more common criticisms are the alleged failure of the beneficiary governments themselves to make commensurate sacrifices for national development and the impulse to socialism that is given by the governmental direction of development made possible by these grants. It is not the writer's purpose to discuss here the merits or demerits of the foreign aid program or the factual justification for the cited criticisms of it. Suffice it to say that right or wrong, the policy seems settled, and the criticisms, if true, are damaging to its objectives.

Analyzed in the framework of these premises, the above described effect of the federal taxation of foreign source income represents nothing less than the thwarting by tax policy of a foreign government's efforts to achieve by its own sacrifices the very development for which U. S. public funds are being showered abroad. The International Cooperation Administration may present a foreign government with a million dollars for a steel mill or an irrigation project, which the government will likely direct and administer. But if the same government should offer a U. S. steel company a five-year income tax exemption to invest a million dollars in the same way, the U. S. Treasury and not the U. S. steel company would benefit from the inducement offered.

It would seem logical for the United States Government to welcome and support a foreign government's own program for economic development. It would seem logical for the leading exponent of enlightened capitalism not to cancel out foreign inducements to attract private American capital to its economy. And it would seem logical for the United States Government not to place its corporations in such a position taxwise that they cannot benefit financially from the sparing of a foreign tax while British, German and other foreign corporations can.[6]

The representatives of capital-importing countries for years have recognized and protested this frustration of their efforts to attract private United States capital by tax concessions, stressing that the U. S. tax policy is in manifest conflict with the U. S. foreign policy of encouraging the economic development of friendly countries. Heeding the vigor of this criticism, Secretary Humphrey publicly declared at a meeting of American Ministers of Economy and Finance, held at Rio de Janeiro in November 1954, that he would favor a tax treaty " giving credit for general foreign

[5] Sec. 911 (a) (2) limits the exclusion to $20,000 for a full year.

[6] It is true that the tax laws of the United Kingdom, Germany and other capital-exporting countries subject to income tax all the profits of *resident* companies, regardless of the source from which derived. But the United States taxes all profits of a corporation *organized* under domestic law regardless of the place of its management or activities. A company organized under British law to operate in Pakistan can arrange to pay no tax to Great Britain on its foreign source income by the simple expedient of locating its management and control abroad.

income taxes which are waived for an initial limited period as we now grant credit for taxes which are imposed." The President has since expressed agreement with these views.[7] Article XV(1) of the proposed treaty with Pakistan is the first attempt to give them legal effect.

For a presentation of how this article would operate, a brief sketch of the Pakistan income tax structure is necessary. Generally, the profits of a foreign corporation engaged in business in Pakistan are subject to: (a) a Business Profits Tax of 16-2/3 per cent imposed on all profits in excess of 6 per cent of " capital employed in the enterprise " in Pakistan; (b) an Income Tax of 31-1/4 per cent, is imposed on all profits, reduced by the Business Profits Tax, and (c) a Supertax of 25 per cent, is imposed on all profits, reduced by the Business Profits Tax. If the foreign corporation elects to operate in Pakistan through a Pakistan corporation, the Pakistan subsidiary's profits are subject to the above taxes except that the rate of supertax will be 18-3/4 per cent if the company is managed and its dividends are declared in Pakistan.

But the dividend of this subsidiary, being income from Pakistan, will be subject to tax to the foreign parent corporation. As a dividend is not business income, the Business Profits Tax will not apply. The income tax of 31-1/4 per cent applies in theory, but like the British standard company tax, it is deemed paid by the company on behalf of the shareholder in respect of distributed profits and is not collected a second time. The Supertax paid by the company, however, is not attributed to the shareholder, but must be paid on the dividend by the declaring company which acts on behalf of the shareholder, withholding the tax out of the dividend. The dividend so taxable, moreover, is " grossed up " by the amount of the income tax—that is to say, the supertax withheld is imposed on an amount equal to the dividend plus the income tax paid on that amount of profits. Normally the supertax rate on the foreign corporate shareholder is 25 per cent, or 4 annas in the rupee.[8] But by article VI(2) of the treaty this rate would be reduced by 1 anna to 18-3/4 per cent.

To encourage development, section 15B of the Pakistan income tax law provides tax concessions for profits from favored new industries established between August 17, 1947, and March 31, 1958. Since initiation of the concessions it has been customary to extend the latter date from year to year by annual amendment to the income tax act. (After the submission of the article for publication, the author was advised that the Pakistan tax concessions for favored new industries have been extended to March 31, 1959.) To qualify for the concessions, the new industry must engage in the manufacture or processing of goods, shipbuilding, navigation, the production of electricity or water-power, mining, petroleum extraction or " any other industrial undertaking " to which the sections shall be declared applicable by proper authority. It is also necessary for a beneficiary to show that he employs at least ten persons and uses mechanical energy or that he employs at least 20

[7] See *Economic Report to the Congress*, dated January 23, 1957, page 55. The three prior Reports include references to the same effect.

[8] Pakistan tax is not usually expressed as a percentage, but as so many annas. There are 16 annas in a rupee, now equivalent to United States $0.21, and 12 pies in the anna.

persons if he does not use mechanical energy. An enterprise officially determined to be qualified is granted total exemption from the Business Profits Tax without limitation as to time, and exemption from the income tax and supertax for the first five years on an amount of income equal to 5 per cent of the capital employed in Pakistan. If the qualified enterprise is a company, the exemption extends to supertax on a dividend to the extent that it represents a distribution of exempt profits.

The benefits may be illustrated by examples.

First Example: A United States corporation which manufactures rope establishes in Pakistan a branch to which it transfers cash and property worth Rs. 2,000,000 ($420,000). This capital is invested in a factory in which electric energy is used and a hundred persons are employed. The enterprise is officially recognized as qualified for the benefits of section 15B. During the first year of operation the branch earns a small profit of Rs. 50,000 (U. S. $10,500). As this profit is less than 5 per cent of the Rs. 2,000,000 capital employed in Pakistan, all of it is exempt from Business Profits Tax, income tax and supertax. Without the benefit of section 15B, however, there would be no business profits tax anyhow since by the law profits in an amount equal to 6 per cent of employed capital are exempt. The income tax of 5 annas, or 31-1/4 per cent, on the profits would be Rs. 15,625, and the supertax of 4 annas or 25 per cent would be Rs. 12,500, or a total tax of Rs. 28,125 (U. S. $5,906).

The United States corporation will be required to include in its income $10,500, representing this profit, and to compute on it a tax at the rate of 52 per cent (maximum), or $5,460. If the spared Pakistan tax of $5,906 had been paid, that amount could be credited[9] against the $5,460 federal tax, discharging thereby the entire tax obligation to the United States. Without payment there would be no credit allowable. By virtue of article XV(1) of the treaty, however, the $5,906 can be credited in the same manner as tax paid even though it is not paid, but spared under section 15B.

Second Example: During the second year of its operation in Pakistan the United States corporation earns a profit of Rs. 150,000, equivalent to U. S. $31,500. As this amount exceeds 6 per cent of its capital employed in Pakistan (6 per cent of Rs. 2,000,000 is Rs. 120,000) by Rs. 30,000, the Business Profits Tax of 16-2/3 per cent, or Rs. 5,000, would normally be payable and could be deducted from profits in computing the income tax and supertax. But an enterprise qualified for benefits under section 15B is wholly exempt from the Business Profits Tax. The amount of this tax spared, however, is not allowed as a credit against United States tax by article XV(1) of the treaty. For these reasons, therefore, the Business Profits Tax may be wholly ignored.

The entire profit of Rs. 150,000 is subject under the law to an income tax of 5 annas, or 31-1/4 per cent, which amounts to Rs. 46,875, and in addition to a supertax of 4 annas, or 25 per cent, which amounts to Rs. 37,500. The total tax is thus 56-1/4 per cent, or Rs. 84,375, equivalent to $17,719. But as the corporation is entitled to the benefits of section 15B, profits of an amount equal to 5 per cent of the Rs. 2,000,000 of capital employed in Pakistan, or Rs. 100,000 are exempt from income tax

[9] Under section 901 of the Code.

and supertax. In figures the tax amounts forgiven are Rs. 31,250 and Rs. 25,000, respectively, or a total of Rs. 56,250 ($11,813). On the profits above Rs. 100,000, or Rs. 50,000, the taxes are, of course, payable and amount to Rs. 28,125 ($5,906).

For the second year of Pakistan operations the United States corporation will be required to include in its income $31,500, representing the profits of Rs. 150,000, and to compute on it a 52 per cent (maximum) income tax of $16,380. Under section 901 of the Internal Revenue Code the Pakistan tax actually paid, or $5,906, can be credited against the United States tax, leaving $10,474 to pay. But by virtue of article XV(1) of the treaty the taxes spared, amounting to $11,813, can also be credited, completely absorbing the amount of United States tax payable. It is to be noted that no credit could be claimed for the Business Profits Tax of 16-2/3 per cent, which is also spared but is not allowed for credit. As the exemption of this tax is of unlimited duration, and by statute it does not apply in any event to a 6 per cent return on employed capital, it was not included in the credit expansion of article XV(1).

Third Example: The foregoing examples are based on a branch operation of the United States corporation. The corporation may, however, prefer to conduct its activities in Pakistan through a Pakistan subsidiary company, thereby avoiding all United States tax on undistributed income of the subsidiary, but, as will be shown, attracting a Pakistan tax on dividends. If it be supposed that the branch operations are conducted by a subsidiary Pakistan company with the same income results, then for the first year there will be no Pakistan tax at all, and likewise no United States tax if no dividend is paid.

For the second year the income tax at the rate of 31-1/4 per cent is spared on Rs. 100,000 of profits and paid on Rs. 50,000, the amounts spared and paid being, respectively, Rs. 31,250 and Rs. 15,625. But as the parent corporation could and did easily arrange to have the Pakistan company pay its dividends in Pakistan, the supertax is not 4 annas but 3, or 18-3/4 per cent, and hence the supertax spared on profits of Rs. 100,000 and paid on profits of Rs. 50,000 amounts, respectively, to Rs. 18,750 and Rs. 9,375. The combined taxes spared were hence Rs. 50,000 ($10,500) and the combined taxes paid were Rs. 25,000 ($5,250).

Out of the profits of Rs. 150,000 the Pakistan subsidiary company declares and pays a dividend of Rs. 75,000. In the hands of the United States parent, this dividend is taxed by Pakistan as income of Pakistan source. It is obviously not business income, and hence the Business Profits Tax does not apply. The income tax paid by the subsidiary discharges all obligation for that tax, and as the parent is (it will be supposed) a public company [10] which is not itself managed in Pakistan, the supertax is 4 annas, or 25 per cent, by law but under article VI(2) of the treaty, this rate is reduced by 1 anna to 3 annas, or 18-3/4 per cent.

But as heretofore pointed out, the supertax on the shareholder is computed on his grossed up dividend. "Grossing up" is normally achieved by subtracting the tax rate of .3125 from 100 per cent, and dividing the resulting .6875 into the Rs. 7500 dividend. But as only

10 A public company in Pakistan is distinguished from a "private" company in which share transfer is restricted and the number of shareholders limited.

a third of the profits has borne Pakistan tax, only one-third of the rate is taken into account for the grossing up. Consequently one-third of .3125, or .10417 is subtracted from 1.00, and the resulting .89583 is divided into Rs. 75,000. The quotient is a grossed up dividend of Rs. 83721 ($17,581.41) on which the normal rate of 4 annas, or 25 per cent, to the parent is reduced by the treaty to 3 annas, or 18-3/4 per cent. The tax normally payable by withholding is Rs. 15,698 ($3,296.58). But as tax was spared on two-thirds of the profits out of which the dividend was paid, so two-thirds of the supertax on the shareholder is spared, and consequently only Rs. 5,232.66 ($1,098.86) is collected by withholding from the dividend as tax on the parent.

To claim foreign tax credit, the parent corporation must include in income the dollar equivalent of the grossed up dividend, or $17,581.41. On this amount the United States tax of 52 per cent (maximum) will be $9,142.12, and against that amount the parent may credit in full the Pakistan supertax of $3,296.58, of which only $1,098.86 was paid. In addition the income tax and supertax paid by the subsidiary on profits constituting the dividend may be credited. As the combined rates of the two, 31-1/4 per cent and 18-3/4 per cent, are 50 per cent, the amount is 50 per cent of $17,581.41, the dollar equivalent of the grossed up dividend, or $8,790.70. The sum of the tax on the parent's dividend and on the subsidiary's profits is $12,087.28, of which a third was paid and two-thirds was spared. The sum is available for foreign tax credit, but exceeds the United States tax of $9,142.12 by $2,945.16. Thus all obligation to pay United States tax is absorbed and an excess credit of $2,945.16 cannot be used.

Fourth Example: In the three examples given the supposed profits have represented a small return on the capital employed—7-1/2 per cent or less. As the normal Pakistan tax rates combined exceed the 52 per cent rate of the United States, and as the credit for tax spared is limited to Pakistan tax on profits representing only a 5 per cent return on capital, it is pertinent to give some indication of the tax situation of the very prosperous Pakistan activity. For this purpose let it be assumed that the above United States corporation, which invested Rs. 2,000,000 in its Pakistan operations, earns 25 per cent, or Rs. 500,000, in a year for which income and supertax are spared.

As the Business Profits Tax is spared, on all profits, the income tax is 31-1/4 per cent and the supertax is 25 per cent, the total taxes on Pakistan profits of a foreign corporation not managed in Pakistan aggregate 56-1/4 per cent. This tax will exceed the 52 per cent (maximum) United States tax, and will offset it. Of the profits of Rs. 500,000, Rs. 100,000 (5 per cent of capital) will be exempt; profits of Rs. 400,000, will be taxed at 56-1/4 per cent or Rs. 225,000. Expressed in dollars the branch profits are $105,000. The normal tax and supertax at 56-1/4 per cent amount to $59,062.50, but those on $21,000 or $11,812.50, are spared while those on $84,000, or $47,250 are paid. The United States tax on $105,000, or $54,600, is absorbed by the Pakistan tax, aggregating $59,062.50, and there remains unused a credit of $4,452.50. But the United States corporation will actually pay $47,250 tax on profits of $105,000. The tax paid is equivalent to

45 per cent of profits, or a tax-saving at the 25 per cent return level of 7 tax rate percentage points. The benefit granted the Western Hemisphere Trade Corporation, which does not fluctuate, is about 14 percentage points. In principle, then tax saving under article XV(1) decreases percentage-wise as the rate of profit return on capital in Pakistan increases.

Fifth Example: As the operation in Pakistan through a subsidiary Pakistan company results in an additional tax on any dividend paid to the parent, the tax burden is greater in respect of profits distributed, but of course those accumulated are not taxed at all by the United States, and the supertax on them is reduced from 25 per cent to 18-3/4 per cent. If it be assumed that the branch profits discussed in Example Four had been earned by a Pakistan subsidiary company, the following picture emerges:

The profits of Rs. 500,000 ($105,000) are wholly exempt from Business Profits Tax; Rs. 100,000 are exempt from income tax and supertax, and Rs. 400,000 are subject to the income tax of 31-1/4 per cent and to a supertax reduced by rebate to 18-3/4 per cent, or a combined rate of 50 per cent. In figures the taxes amount to Rs. 250,000 ($52,500), of which Rs. 50,000 ($10,500) are spared and Rs. 200,000 ($42,000) are paid. Let it be next assumed that a dividend of Rs. 200,000 ($42,000) is declared. Grossed up the dividend amounts to Rs. 266,667 ($56,000), and the 18-3/4 per cent supertax (as reduced by article VI(2) of the treaty) amounts to Rs. 50,000 ($10,500). But as 20 per cent of the profits out of which this dividend is paid, (Rs. 100,000 out of total profits of Rs. 500,000) is exempt from income tax and supertax, so 20 per cent of the dividend is exempt from supertax, and supertax payable is reduced by Rs. 10,000 ($2,100) to Rs. 40,000 ($8,400).

The United States parent corporation must report as income the grossed up dividend, equivalent to $56,000, on which United States tax at the 52 per cent (maximum) rate will be computed as $29,120. Against this tax there may be credited the supertax of $10,500, of which 20 per cent was spared, and the income tax and supertax (combined rate 50 per cent), on the grossed up dividend, or $28,000, of which 20 per cent or $5,600 was spared and $22,400 was paid. The available credit for Pakistan taxes on dividend and subsidiary's profits thus amounts to $38,500, of which $7,700 was spared and $30,800 was paid.

The credit, be it noted, exceeds the United States tax by $9,380, and, expressed in terms of actual benefit, the credit for tax spared cannot be utilized. Under the assumed circumstances of a 25 per cent return on capital, the amount of tax actually paid ($30,800) is about 55 per cent of the grossed up dividend, or about 3 percentage points over the 52 per cent United States rate. There is then no loss to the United States Treasury from a United States taxpayer's gains under article XV(1) if 25 per cent is earned on capital used in Pakistan. As the rate of return is less, the percentage of tax saving is greater; as the rate of return is more, the percentage of tax saving decreases.

Conclusions

It was pointed out above that no credit against United States tax is to be allowed for Business Profits tax spared.

Likewise no credit is to be allowed on account of a number of other tax concessions of Pakistan designed to stimulate economic development. These are:

1. An individual who subscribes for and purchases shares in a new approved public company of Pakistan will get a rebate of both income-tax and super-tax on the amount equal to the investment, but not over 20 per cent of the first 100,000 rupees of income, and 10 per cent of income above 100,000 rupees.
2. The salary of a foreign technician engaged for work in Pakistan with approval of the Central Government is exempt from tax for year of arrival and for following year.
3. Income from newly constructed buildings is tax-exempt up to 3,000 rupees for two years.
4. An extra depreciation deduction of 10 per cent, 15 per cent or 25 per cent (according to type of building) is granted on new buildings for the first year after erection. This deduction is above the normal allowance.
5. An extra depreciation deduction of 25 per cent is granted on machinery and equipment installed for the first time in Pakistan.
6. An additional depreciation deduction equal to the normal depreciation allowance is granted for the first five years on machinery and equipment installed for the first time in Pakistan. Further deduction equal to 50 per cent of the normal rate is allowed for double shift working and 100 per cent for triple shift working.
7. A rebate of income-tax of one anna in the rupee (6¼ per cent) is allowed on the undistributed profits of public industrial corporations.
8. Capital and other expenditure on scientific research, technical training, education and medical treatment of employees is allowed as a deduction from taxable profits.

Article XV(1) of the treaty may be criticized in that the credit allowed for tax spared is narrowly limited to the income tax and supertax of enterprises qualifying under section 15B, and even that benefit is restricted to the corporate taxpayer. Equally cogent reasons, it has been argued would support the allowance of foreign tax credit on account of any Pakistan tax spared to encourage development. Theoretically, this reasoning may be sound, but taxation is a very practical matter, and considerations of an administrative nature cannot be ignored.

Obviously the granting of credit for a foreign tax not paid represents an innovation for which there has been no operational experience. Obviously a blanket concession relating generally to all sparing laws, present and future, would make possible exemptions from United States tax in such a way as to admit of extravangancies or even abuses, and would enable a foreign government, perhaps promoted by an interested United States enterprise, to enact or increase income taxes for sparing only. Furthermore, the Internal Revenue Service should be assured that evidence will be available of the amount of tax spared which is definitely recognized by the foreign tax department just as a receipt for tax paid constitutes such evidence.

As an innovation expected to be a precedent for other treaties, article XV (1) represents a cautious approach. Consistent with this approach, the spared taxes recognized for credit are those imposed by an income tax act which dates back for scores of years; the taxes imposed by it are and have long been of wide and general application so that the general body of

Pakistan taxpayers, not just foreign enterprises, would be affected by rate changes, and the credit is specifically restricted to a specific tax sparing provision of the law, section 15B, which itself dates from 1948. This innovation in tax treaty policy is, therefore, carefully and prudently confined to an established tax policy of Pakistan, which since independence and before has an extended record of orderly tax administration under a law dating back to 1922. Experience under this article should indicate whether or not the granting of credit for foreign tax spared is administratively safe and practical, and whether or not such a credit will attract American enterprise to the treaty country. The political relations between Pakistan and the United States prompt the hope and expectation that this new measure for the encouragement of closer economic ties between the two countries will prove its worth.

THE PAKISTAN TAX TREATY AND "TAX SPARING"

STANLEY S. SURREY *

THE United States has entered into a number of international income tax treaties with various European countries, British Commonwealth countries, Japan, and Honduras. While these treaties are called treaties for "the avoidance of double taxation," for the most part as far as the United States is concerned our Internal Revenue Code use of the foreign tax credit effectively prevents double taxation for our citizens and corporations. Under this credit, the United States permits a taxpayer to apply foreign income taxes against the income tax due to the United States, so that only the excess if any need actually be paid to the United States.[1] As a consequence these treaties really deal with peripheral matters. The usual pattern is for the country of source to reduce its tax on certain forms of income going to the country of the investor. Thus, as respects the United States, it may by treaty reduce its withholding tax on dividends paid by United States corporations to citizens of say, Australia, in return for Australia's reducing its tax on dividends paid by Australian corporations to citizens of the United States. In some situations this reciprocal reduction brings foreign rates down to the level of the United States, so that our corporate investors pay no more than 52 per cent. As another example, taxation at the source on compensation paid to foreigners temporarily residing in a country, such as teachers or businessmen on short trips, is usually waived by a treaty. The foreign country often agrees to institute a foreign tax credit system for its domestic taxpayers respecting their income from sources within the United States. A few source rules are sometimes inserted, which usually reflect the United States rules and probably as well the similar rules already existing in the other country. There are also some provisions for cooperation between the administrative authorities of the two countries.

Thus in the tax treaties in the past the United States has reduced its taxes only on foreign investors receiving income from the United States in return for similar concessions by a foreign country on income going to United States investors. These past treaties—and this is the important point—have not reduced United States tax rates on United States citizens or corporations receiving income from a foreign country.

The Pakistan treaty,[2] however, is the first treaty designed to reduce *the United States tax* on United States corporations investing abroad, thus fundamentally altering the entire tax treaty process. The treaty in all but one of its articles represents the pattern of existing tax treaties. But one sentence in the treaty fundamentally alters that pattern. This is the second sentence in Article XV(1),

* The author is Jeremiah Smith, Jr. Professor of Law at the Harvard Law School.

[1] For a discussion of the foreign tax credit generally, see Surrey, "Current Issues in the Taxation of Corporate Foreign Investment," *Columbia Law Review*, June, 1956, p. 815.

[2] Taxation Convention with Pakistan, Executive N. 85th Cong., 1st Sess. (1957).

which grants the so-called "tax sparing credit."

"Tax sparing" is a term coined to describe tax concessions which some of the foreign countries grant to certain activities, in an effort to encourage those activities. Thus, Pakistan for example exempts from its income tax and super tax for a certain period profits up to 5 per cent of invested capital earned by a manufacturing corporation employing ten or more persons and using power, or employing 20 persons without using power. This provision has the effect of reducing the Pakistan tax on a United States corporation investing in Pakistan, since the United States corporation need not pay the full Pakistan tax—i.e. a part of that tax is "spared." The proposed treaty then states that for the purpose of our foreign tax credit the United States corporation shall still be treated as having paid the Pakistan tax which was spared. In other words the United States corporation is given a credit for the tax *not paid* to Pakistan. It can apply this credit for a tax *not paid* against its United States tax on income from Pakistan. It is obvious that to allow a credit against our tax for a tax *not paid* has the same effect as reducing the United States rate of tax. In fact, the Pakistan tax treaty could in some cases operate to produce just about the 14 point reduction for foreign income which the Congress has so far refused to grant by legislation. Conceivably, in other situations the United States rate on income from Pakistan could be reduced to zero.

This proposal changes the whole nature of the tax treaty process, for it would permit the rates of *United States tax* applicable to a United States citizen or corporation investing abroad to be fixed by treaty. Up to now this vital question of tax policy has been regarded as a matter to be determined by legislation. The tax sparing treaty would instead permit these tax rates to be determined by treaty action rather than legislation.

There are a number of serious objections to this treaty proposal. They are here stated in somewhat summary fashion: [3]

1. In recent years, the Congress has been urged by the Treasury Department and others to reduce the rate of United States corporation income tax applicable to income from foreign sources. Generally this rate is 52 per cent (with the exception of certain Western Hemisphere operations).[4] Thus, it has been forcefully suggested that Congress reduce this 52 per cent rate to 38 per cent. In 1954 this proposal was considered at length but not approved by the Con-

[3] The pressures of publication schedules necessitate this approach. The arguments presented are taken from memoranda submitted to the Senate Committee on Foreign Relations at its Hearing on the treaty, 85th Cong., 1st Sess., August 9, 1957 (an earlier Hearing was held on July 30, 1957) and from a statement and testimony presented to the House Committee on Ways and Means at its invitation on the taxation of foreign income, see *Hearings on General Revenue Revision*, 85th Cong., 2d Sess. (1958), 1143. For further consideration of this matter see the article referred to in note 2, *supra*, and Surrey, "The United States Taxation of Foreign Income," to appear in the forthcoming *Journal of Law and Economics* (University of Chicago).

[4] The text does not take into account significant tax preferences granted to foreign investment under certain circumstances because of the formulas now followed, but probably inadvertently adopted at the beginning, in the calculation of tax credits in the case of subsidiary operation. Thus, where operation is in foreign subsidiary form, given a foreign tax rate of 26 per cent, the effective combined tax rate of foreign and United States tax is 45.25 per cent under the foreign tax credit formulas instead of the expected 52 per cent. Where operation is the form of a chain of a parent and 2 foreign subsidiaries, the bottom corporation being in a country with a tax rate of 25 per cent and the intermediate one in a country with a tax rate of 20 per cent, the effective overall tax for the chain is 40.45 or 43.5 per cent, instead of 52 per cent, depending on which interpretation of the applicable law is followed.

gress. Since 1954 the tax committees, House Ways and Means and Senate Finance, have not given approval to similar proposals. As the record therefore stands respecting direct tax legislation, the Congress opposes the grant of any preferential corporate tax rate on foreign income. The proposed treaty, which would grant a preferential tax rate to foreign income, is thus, as far as one can judge from the public record, directly in contrast to a general tax policy recently expressed against such a preferential rate, and in this particular instance the treaty can go far beyond the reduction to 38 per cent already rejected by the Congress—for it can reduce the effective rate to zero.

This policy conflict, and the consequent importance of the issue, are not limited to the Pakistan treaty. Once this preference is granted to income from Pakistan, it will have to be extended to a great many other countries of the world. The Pakistan treaty, if adopted, is thus the forerunner of what will amount to a general tax reduction respecting foreign income—a result directly opposite to that arrived at in the formulation of our legislative tax policy.

2. The full effect of the treaty can be realized only by placing it in perspective with our foreign tax credit. Congress for years in the internal revenue laws has permitted American corporations to credit foreign taxes paid against their United States tax. This credit is an accommodation to our investors abroad who are subject to tax both in a foreign jurisdiction and in the United States. The credit insures that the investor abroad is not adversely treated as compared with the investor at home—the United States Treasury simply accepts payment of the foreign tax as payment pro tanto of the United States tax bill. The burden of double taxation is thus borne by our Treasury Department. But the important fact is that so far as the United States is concerned the actual tax burden on the investor abroad is not lessened as compared with the investor at home. Both pay 52 per cent—but one pays it all to the United States Treasury and the other pays part to the United States Treasury and part to a foreign government.

The credit was thus directly designed to meet the added tax burden of foreign investment. It is not intended to—and until this treaty did not operate to—reduce the tax burden on the foreign investor below that of the domestic investor.

The tax sparing clause in the Pakistan treaty thus distorts the whole foreign tax credit procedure. Under it a credit is given for a foreign tax not paid. The lessened United States tax bill is thus not balanced by the payment of a foreign tax, as in the usual case—and therefore is a direct reduction in the tax rate applicable to the foreign investor as compared with the domestic investor.

3. If such a tax sparing clause is adopted in the Pakistan treaty and if the policy spreads to treaties with other countries, then the results would be one United States tax rate applicable to United States corporations in Pakistan, another rate applicable to United States corporations in country X, another in country Y, and so on. The United States rate would in effect be set by the finance minister of each foreign country, in the light of that country's overall domestic policies. This would be a far cry from the 52 per cent United States rate applicable today, whether operations are in Pakistan or Brazil or elsewhere. It is

true today that changes in foreign tax rates affect the actual amount of tax dollars collected from a United States corporation. But these changes affect only the relative size of the two components of the corporation's overall tax burden—the United States component and the foreign component. They therefore really affect only the amount of loss suffered by the United States Treasury Department—they do not affect the tax burden on the United States corporation. If the foreign tax rises, our Treasury loses and the foreign treasury gains. If the foreign rate falls, our Treasury gains and the foreign treasury loses. But the United States corporation investing abroad still has its overall 52 per cent burden—just as does the domestic investor.

4. Tax sparing treaties would also discriminate among investors abroad. Thus, these treaties would not apply to all types of foreign source income; for example, patent and know-how royalties are not benefited in the Pakistan treaty. Nor can the treaties apply to all countries, since presumably only countries using income tax rate concessions can enter into tax sparing treaties. Thus, a United States corporation doing business in a tax concession country under a tax sparing treaty would in effect have a lower United States tax rate than a United States corporation doing business in a non-tax rate concession country, although the foreign rates after the concessions are taken into account did not appreciably differ. Hence a United States corporation investing in Mexico or Cuba, tax concession countries, would in effect be granted a lower United States tax than a United States corporation investing in Venezuela or Colombia, which basically are not tax concession countries.

5. The tax reduction which the tax sparing device involves can result in windfalls to United States corporations. The Pakistan treaty is applicable to United States corporations already investing in Pakistan. Thus, though they have invested without any stimulus from or reliance upon the tax reduction now to be granted, they nevertheless receive that tax reduction. Indeed, the United States Council of the International Chamber of Commerce, stresses that these retroactive benefits are just and proper: "The benefits of the tax-sparing provision in the Pakistan Treaty will, fortunately, be available to some American businesses which have already been established . . .".[5] In fact, the Chamber serves notice that it will push for even greater retroactivity if the principle is adopted. But the windfall aspects of this retroactive application of the treaty tax reduction are obvious.

Moreover, advantages which are in effect windfall gains are also present even in the case of future investment. Most sound American investment abroad is predicated on the long-range situation, and is planned to last long beyond the tax concession period of foreign tax laws. Consequently, the real inducement to this investment is the long-range investment climate and not the short-range tax concession. Hence, the United States tax reduction granted under this treaty proposal when effective for the initial period of investment, as it would be in the case of a branch or a foreign subsidiary distributing some profits to the United States parent, is in effect a windfall benefit—bestowed for engaging in an activity which would have been engaged in without that benefit.

6. This tax reduction could encour-

[5] See *Hearings*, July 30, 1957, note 3, *supra*, at p. 22.

age operators to seek a quick profit—to operate for the period of the tax concession, obtain a United States tax reduction, and then end their operations. This has been the case in some underdeveloped countries. Such a situation is hardly beneficial to the underdeveloped country and this is hardly the kind of activity which the United States should induce and favor with a United States tax reduction. The treaty proposal is thus really an incentive to a quick repatriation of foreign profits rather than to a continued reinvestment abroad of these foreign profits—whereas one would think that just the opposite effect would be desired. Moreover, as has been pointed out, what is to prevent the activity from being liquidated and then started over again in somewhat variant form with a new tax concession.[6] The treaty itself, and hence the United States tax law, does not prevent this. The question is simply one of Pakistan tax law—what is a " new undertaking " under that law. Thus the scope of the tax reduction in the United States tax depends on the interpretations, effectiveness of audit scrutiny, ability—and even honesty—of the foreign tax administrators. They and not we become essentially the policemen of United States tax reductions for United States taxpayers.[7]

[6] See remarks of Senator Kennedy, *Hearings*, July 30, 1957, note 3, *supra*, at p. 10.

[7] A number of other matters will turn on Pakistan law. Thus, the amount of capital invested is determined under Pakistan law, and not United States law. This amount is not an easy matter to determine, as experience in a somewhat similar situation in United States excess-profits tax history shows. Not only must the capital invested be determined precisely, but also the amount of capital allocable to the exempt activity. Where some exempt and some nonexempt activities are involved, this allocation can be quite complex. Here again the policeman of the United States tax reduction is the foreign tax administrator, for his decisions on these difficult legal, accounting and factual questions decide the point.

7. It is asserted in support of the tax sparing treaty proposal that the United States tax laws " nullify " and " frustrate " the tax concessions which some underdeveloped countries grant under their tax laws and that therefore these tax sparing treaties are necessary. This assertion is one of the basic arguments offered in support of the proposal. However, this assertion is "greatly exaggerated," to use the characterization given to this assertion by Professor Dan T. Smith, Deputy to the Secretary of the Treasury, in a speech on this subject before the National Foreign Trade Council, November 28, 1956. To quote Professor Smith:

> " It is asserted that our tax system nullifies the tax advantages which other countries attempt to offer because the taxes which they forego, by reducing the tax credits which we allow, simply increase the tax in this country by the same amount. This criticism is greatly exaggerated; it is valid only when foreign operations are conducted directly rather than through foreign subsidiaries or through foreign subsidiaries from which all income is currently withdrawn. Where foreign subsidiaries are used the common expectation is that early earnings will be retained indefinitely and used for expansion. Typically the period of retention for expansion will equal to exceed the period of tax concessions, and when this is the fact, the foreign tax concessions are fully effective."

Thus, the basic reason advanced for this treaty proposal, that of nullification of foreign tax concessions, simply cannot be supported. When American business invests abroad in foreign subsidiary form, these foreign tax concessions are effective. Only the foreign tax is applicable to a foreign subsidiary, and the United States tax does not apply until dividends are paid to the United States parent. Moreover, in the over-

whelming majority of cases when our industrial concerns operate abroad they do so in foreign subsidiary form. Branch operations abroad—the situation in which the foreign tax concession may not be fully effective—are found generally (aside from certain Western Hemisphere operations which already enjoy a favored status) only in the case of oil and other natural-resource industries. But in these natural-resource activities the investment basically follows the resource and not the tax concession.

8. It is pertinent to note at this point that Britain has concluded a tax treaty with Pakistan and this tax treaty does not have any tax sparing provision in it. In fact, though the British originally suggested in 1953 that consideration be given to the tax sparing device, they have not adopted it and instead have sought other solutions. The solution adopted in 1957 in Britain embodies the tax deferral approach inherent in our tax rule regarding foreign subsidiaries. Under that solution, a special class of British corporations known as overseas trading corporations may engage in foreign operations, under certain conditions, free of tax until distribution is made to shareholders. In effect, the British in their 1957 solution have really gone no further than where we in the United States have always been as respects our foreign subsidiary rule, except that actual foreign incorporation is not required.[8]

9. Another argument presented for the tax sparing treaty device is phrased along this line: Since the United States concedes the power of the foreign jurisdiction to tax, we can just as well through tax sparing concede them the power to forego taxes. Thus far, of course, the assertion is meaningless for we do not in any way tell a foreign country that it cannot reduce its taxes if it so desires. Hence, the assertion must be made even more strongly: We must recognize the right of the source country to forego some of its tax without our " stepping in " and " nullifying " their action. The phrase regarding our " stepping in " is a curious one. For what this assertion comes down to is that we must recognize the right of the source country to forego taxes and that such recognition requires that we stop levying United States taxes on United States corporation on profits subject to United States tax, even though this means that these corporations end up with tax burdens less than those of other United States corporations. So stated, it is obvious that the recognition granted under the foreign tax credit to the jurisdiction of the foreign country to tax at source hardly carries with it the corollary that we must also accommodate our tax laws to waiver or absence of tax in the foreign country.

What the proponents of this treaty device are really asserting is that the United States should give up its basic principle of equality of tax burden on United States taxpayers. For this principle can only be maintained by adherence—as we have done from the start of the income tax—to the concept that the United States can tax its citizens and corporations on their worldwide income. Yet it is this basic and longstanding concept which the proponents of the tax sparing device are asking the Congress to abandon.

10. The underdeveloped countries differ widely in the extent to which they

[8] See in general Harvard Law School, International Program in Taxation, World Tax Series, Taxation in the United Kingdom, prepared by Brudno and Bower, 1957 and 1958 Supplements; Bronheim, Overseas Trade Corporations—A United Kingdom Experiment, 35 *Taxes* 771 (1957).

adopt tax concessions to encourage investment and in the types of concessions used. There are differences in the taxes involved—income tax, excess-profits tax, company tax, customs duties and import taxes, sales taxes, property taxes; in the activities affected—manufacturing, mining, "new industries," "essential industries," "convenient industries," "pioneer industries," "basic industries," "approved industries;" in the period for which the concession is granted—5 years, 10 years, 20 years, 25 years; in the amount of reduction in income tax granted—complete exemption, 100 per cent in the first few years down to 25 per cent at the end, 40 per cent of tax, all profits up to 5 per cent, 10 per cent, etc. of invested capital; in the type of income tax concession used—exemption, rate reduction, increased depreciation allowance, deduction for profits reinvested. Some countries, of course, do not grant any concessions.

The tax sparing device inevitably involves the United States and the Senate Foreign Relations Committee in picking and choosing among all of these concessions. It requires our becoming directly involved in the fiscal policies of all of these countries. It will bring pressures to bear on the use of the exemption-type concession. For the tax sparing device requires the type of concession that permits ready identification and calculation of the "tax spared," so as to make administration of the device at all possible. After all, to credit a tax not paid one must be able to identify accurately what was not paid. The exemption concession is of this type, though it is not without its many problems. Yet many underdeveloped countries are finding that other concessions, such as increased depreciation or an investment allowance, are more desirable. The tax sparing device, with the pressures it exerts in one direction, can be more of an interference with foreign tax laws than anything yet suggested in this field.

Suppose the United States places its blessing on a particular income tax exemption or rate reduction in a particular country and enters into a tax sparing treaty with that country. The result will be a decrease in the United States tax rate. Then suppose the country adopts a different concession, or drops concessions entirely in favor of a lower tax rate generally. Thus, Pakistan as a result of a tax revision study now in progress may decide that its tax rates—which are among the highest in the world—are too high to encourage domestic capital formation and they should be reduced for all taxpayers, with concessions limited or even abandoned. The United States tax rate would then increase on the taxpayers involved. A device that has the *United States tax burden* bobbing around as foreign countries experiment with different fiscal policies is an almost fantastic approach to international tax problems.

11. The use of tax treaties to establish rates of tax on United States corporations has serious political considerations both here and abroad. The result will be to focus intense lobbying pressures by a combined group of United States foreign investors and tax concession countries on the Treasury Department to obtain favorable treaties, and for the first time saddle the tax treaty process with intensive lobbying activity. Also, this device will focus pressures on United States corporations to obtain tax concessions from underdeveloped countries and then have the tax concessions written into a treaty—since this is the route which will reduce their United States taxes.

A searching question exists whether a resort on our part to the tax sparing device would not in the end be basically injurious to the economies of underdeveloped countries. This device favors a country with an unstable and unrealistic high rate tax system shot through with tax concessions, many of which are contradictory and self-defeating. As such it tends to postpone intelligent revision of foreign tax systems. Moreover, these countries desperately need revenue for public projects. Encouragement on our part to pressures for tax concessions by these countries—an encouragement inherent in the tax sparing device since the tax concession means reduction in United States tax—may well result in depriving them of revenues they could just as readily obtain. The rash of incentives and concessions might well pass more quickly and be followed by stable and realistic laws but for a treaty device which encourages our investors abroad to bring pressures on foreign countries to grant tax concessions.

12. The tax sparing device has been defended on grounds of the need of a United States tax incentive to encourage United States private capital to invest abroad. The wisdom of using tax incentives for this purpose is itself highly debatable.[9] But whatever the outcome of this issue, it would certainly appear that the particular device here suggested, the " tax sparing device," is fundamentally an unsound one to offer as a worthwhile tax incentive. It does not begin to answer any of the problems that must be faced when a tax incentive is to be used. Thus, is there any evidence as to how one can tell in using this tax-sparing device just how much tax relief is needed for an effective incentive? If the effect of the incentive is insignificant—and an experienced witness stated to the Senate Committee on Foreign Relations that no serious amount of capital would be attracted because of this device in the Pakistan treaty[10]—then a tax windfall has resulted and our Treasury has lost revenue for no real purpose. Further, how do we recognize which are the countries to which American investment should be directed by tax incentives? Certainly the test cannot be simply those countries which offer tax concessions. Yet this appears to be the sole criterion under the tax sparing device. Further, how do we recognize which are the types of activties to which American investment should be directed and how do we devise methods which would channel the tax incentive so as to draw forth new investment? The tax sparing device, if it answers these latter problems at all, does so really by relegat-

[9] See Surrey, " Current Issues in the Taxation of Corporate Foreign Investment," *Columbia Law Review*, June, 1956, p. 815.

[10] The representative of the United States Council, International Chamber of Commerce, stated to the Senate Foreign Relations Committee: " I want you gentlemen to know and anyone else who wants to know, including the executive departments and Pakistan, that in my humble opinion virtually no capital from the United States will be attracted to Pakistan under the present Pakistan regime and under this treaty." He urged approval of the treaty, however, because the " psychological repercussions of disapproval " would be bad. See *Hearings*, August 9, 1957, note 3, *supra*, at 52.

See also the statement of John M. Barker, House Ways and Means Committee, *Hearings on General Revenue Revision*, 85th Cong., 2d Sess. (1958), 1173, which reaches the same conclusion in effect, but goes on to say that the treaty should therefore be approved since no United States corporation will benefit and no harm is done. But this view completely ignores the precedent aspect of the treaty, which is the heart of the problem. See point 16 in the text.

The Puerto Rican experience with tax incentives, whatever it does show, is hardly typical in view of the free and close access to the United States market, no currency problems, participation in United States legal and political institutions, and the like. As to Puerto Rico in general, see Stead, *The Economic Development of Puerto Rico* (National Planning Association, 1958).

ing all these problems to the policy decisions and rulings of foreign finance ministers and foreign officials. Yet these are exceedingly difficult problems to solve and it is certainly a curious solution that says the course and application of United States tax incentives basically should be decided not by us but by foreign officials, especially when these very foreign officials recognize their own limitations and even failures in meeting these problems. It is not enough to say in response that all of this is a matter of treaty negotiation. For the very insistence on negotiation indicates the inherent weakness of the tax sparing device as a method of developing a clear-cut policy for granting a tax incentive for United States investment abroad. While the absence of any guiding standards to solve the basic questions enumerated above undoubtedly means that the tax sparing device can only be applied through ad hoc negotiations in treaties, this absence of standards hardly thereby becomes a virtue.

13. It is sometimes argued that all these admitted serious defects of the tax sparing device are counterbalanced by the international benefits which the device will provide. However, it is generally agreed that tax sparing will not increase United States investment abroad.[11] Rather, in defense of tax sparing, it is said that underdeveloped countries resent the United States policy of taxing foreign source income and that tax sparing will therefore remove some of that resentment and create good will. This resentment, however, is really the reflection of an assertion that only the source country should control the taxation of international investment—an assertion which the United States and many other countries, including some Latin-American countries, have long rejected.[12] Moreover, as respects a balancing of the claims of the investor country and the source country, the United States has already gone far in seeking an international accommodation through its foreign tax credit and foreign subsidiary rules. To ask the United States to go further and violate its own basic principle of not discriminating among its own nationals—which is what the tax sparing treaty asks us to do—is not warranted as an international matter. In effect, the United States so long ago acted by unilateral legislation to relieve these problems of international taxation that the underdeveloped countries experiencing significant United States investment for the first time tend to forget what we have done. To the extent that resentment exists in these countries, it is in many instances due to a lack of information as to our tax rules and a failure to appreciate the effects of the basic accommodations we have already made to international investment.

Thus, there is probably no real recognition of the aid to economic development represented by the foreign tax credit. As between developed countries, the foreign tax credit when used by both countries is really an exchange between Treasury Departments. Investment and business profits flow both ways, and credits granted by the United States for payments at source to the other country are offset by taxes withheld by the United States at source and credited by

[11] See note 10, *supra*.

[12] Mexico, for example, has jurisdictional tax rules respecting foreign income that are about the same as the United States—it taxes the world wide income of its citizens and corporations and grants a foreign tax credit. A number of Latin-American countries also tax the foreign income of resident individuals and corporations under their global or complementary taxes and corporate income taxes.

the other country.[13] But between the United States and an underdeveloped country, the foreign tax credit is a one-way flow from the United States Treasury, since the underdeveloped country usually does not have investments in the United States from which our Treasury can collect a tax at source. Here our foreign tax credit permits appropriate tax revenues to be collected in the foreign country on investment from abroad without the deterrent effect on the importation of outside capital that would otherwise exist if the resulting double taxation were not eliminated by the credit. As a striking example, the economic development of Venezuela is in a sense being financed to an appreciable extent by the United States Treasury through the foreign tax credit granted for the Venezuelan taxes on oil. As a continuing aid to underdeveloped countries and one that does not have to be directly reflected through budget appropriations, the foreign tax credit is very significant.

All this being considered, a case cannot be made on the basis of international goals which is at all strong enough to justify the admittedly undesirable effects of the tax sparing device.

14. It is urged that the tax sparing device has a " symbolic value " and that it is justified by its " emotional appeal." But symbols and emotions will hardly be of aid to the Senate Foreign Relations Committee when it must decide the questions that lie ahead and when it must face the pressures that this device will inevitably bring. Already warning has been served by American investors that these pressures are to come: The National Foreign Trade Council has said that the tax sparing device in the Pakistan treaty " should be implemented more broadly in future treaties." [14] The United States Council of the International Chamber of Commerce has critized the restriction of the Pakistan law to new undertakings. It therefore urges that the Committee make it clear that the Pakistan treaty is not a precedent that discrimination by foreign countries against existing businesses should be accepted by the United States. Moreover, it points out that the Pakistan tax concession is keyed to a fixed rate of return on invested capital and urges that application of the tax sparing device to this concession not be considered as limiting use of the device in future treaties to this one type of concession.[15]

It is clear that strong pressures are in the making for a wider and wider application of the tax sparing device and its accompanying reduction in United States taxes once a precedent is set in the Pakistan treaty. And, judging from our experience in tax legislation, one can hardly be sanguine about any attempts to confine a tax reduction proposal once it has been adopted and pressures such as the above set in motion. Certainly " symbolic value " and " emotional appeal " will not furnish strong guidance to the Senate Foreign Relations Committee. Tax history is replete with examples of the fact that major loopholes develop from preferences that initially appear to be quite limited.

15. Perhaps this view of the matter may mean fewer tax treaties with underdeveloped countries. But, as noted earlier, these treaties are distinctly marginal matters. In fact, since the pattern of the treaties is for the country of source to yield tax revenue, these treaties

[13] Froomkin and Wender, " Revenue Implications of United States Income Tax Treaties," *National Tax Journal*, June, 1954, p. 177.

[14] See *Hearings*, July 30, 1957, note 3, *supra*, at p. 20.

[15] *Ibid.*, p. 22.

are not suited to underdeveloped countries hard pressed for revenue. Certainly the United States should not be pushing for tax treaties of this character as respects underdeveloped countries. A pattern of tax treaties with underdeveloped countries under which the United States would grant tax sparing, despite all its basic defects, as the concession for obtaining tax reductions at source from the underdeveloped countries, despite their desperate revenue needs, would certainly be the wrong policy on both sides.[16] It would match two ill-advised concessions with no basic gains achieved, since it is generally agreed that such treaties would not achieve any real increase in desirable international investment.[17] And probably underdeveloped countries seriously desiring tax treaties would in time be willing to negotiate them without the tax sparing device.

16. It is clear that a very significant precedent is involved in the adoption of this tax sparing device. It is not just a little clause in the Pakistan convention. It presents a very fundamental question of tax policy. Once adopted, it will be a precedent which cannot be withdrawn. Arguments in support of tax sparing based on the small amount of tax spared in the Pakistan situation and examples showing how little United States tax will be saved are thus completely beside the point. The basic issue is the tax sparing device itself, and not its application in the Pakistan treaty. Once the tax sparing path is taken, the United States and the Senate Committee on Foreign Relations are involved in endless choices among foreign countries, among different tax concessions and among different United States taxpayers. Moreover the Committee will be thrown into these problems without any rules or standards to guide it.[18]

16 As respects Pakistan, the Department of State, *Hearings*, July 30, 1957, note 3, *supra*, has said that the United States must insist in a tax treaty that the country of source, here the underdeveloped country, give up its tax on royalties paid to United States licensors of patents, know-how, and the like. Yet by and large, as a result of our foreign tax credit, taxation at the source is not a basic obstacle to licensing abroad. At the same time, as a result of the increasing desire of United States corporations to license abroad and of the desire of underdeveloped countries to receive such technological aid, our insistence that underdeveloped countries yield their tax on outgoing royalties can deprive them of needed revenues. In view of the foreign tax credit, moreover, this insistence does not benefit the United States taxpayer but only the United States Treasury.

This insistence, therefore, is hardly in keeping with the arguments earlier advanced that tax sparing is necessary because otherwise the United States Treasury would benefit from the tax concessions in the foreign country. This is but one example of the contradictions involved in insisting that underdeveloped countries yeild their general source taxes and at the same time insisting that we should aid their economic well-being. Taxation at the source on income flowing to the United States is onerous to the United States taxpayer if it brings his effective tax burden above the United States rate. But unless it does this, the effect of the foreign tax is not felt, and the real loss is to the foreign country if it must yield beyond this point. There is therefore little reason to insist, as the State Department memorandum urges we must, on any sacrifice in revenue by these countries. Once having decided to eliminate double taxation through the foreign tax credit device, there is no reason for us to insist on eliminating it all over again in another way by making the underdeveloped country sacrifice its revenue sources.

There are some marginal cases where the foreign corporate rate is in excess of the United States rate. Here the foreign country, if it desires to attract foreign capital, will find that in its self-interest it may want by treaty to lower that rate to the United States rate if the higher rate is actually a deterrent to foreign capital. But as respects these underdeveloped countries, they will probably come to realize that such extremely high corporate rates are also a deterrent to domestic capital formation and therefore they will have to revise their revenue systems generally. Giving encouragement to tax concessions in such a situation really postpones desirable basic reconsideration of these tax systems. See point 11 in the text.

17 Tax treaties with underdeveloped countries could consider various matters as administrative cooperation, source reduction as respects short trips of scholars and businessmen, and the smoothing out of uncertainties in source rules, all without any significant concessions being required.

18 (See next page)

* * * * *

In sum, the tax sparing proposal is a fundamentally unsound and dangerous approach to the problems of international taxation. It should be firmly rejected, so that consideration may be given to other approaches that appear to be far more fruitful.[19]

[18] Pakistan in its recent tax law, the Finance Act of 1958, approved March 26, 1958, apparently has refused to extend the tax concession here involved past March, 1958. Hence, no business established after that date in Pakistan can obtain the concession. This action underscores the transitory nature of these concessions. One hears that other underdeveloped countries are also giving a severe second look at their tax concessions. If Pakistan itself is so dubious about these tax concessions, there is certainly no reason for the United States to have to adopt tax sparing as a precedent, with all its admitted problems and difficulties, just because it happens to be in the Pakistan treaty presented to the Senate Foreign Relations Committee. The situation is thus one in which that Committee can with no real difficulty stop at the very start what would otherwise be the commitment of the United States to an unsound position in the international tax field.

[19] For example, it would be desirable to explore a deferral approach, similar to that of Great Britain, which has been suggested for the United States through recognition of a special type of United States corporation having only foreign source income. See House Ways and Means *Hearings*, note 3, *supra*, at 1153 and article cited in *Journal of Law and Economics*, note 3, *supra*.

INDIVIDUAL INCOME TAXES AND HOUSING

BRUCE LEE BALCH *

Introduction

THIS paper will explore and comment upon the various provisions of the present federal individual income tax law which have some substantial impact on housing. An attempt has been made to discover the purposes which motivated the Congress to include these sections in the law by tracing the applicable legislative history. Where appropriate, changes in the Code have been proposed.

The tax law influences all economic activity by several major methods: exclusion of certain forms of income by deliberately omitting them from the definition of gross income, specific exclusion of certain income items from taxable income, permission of deductions which reduce taxable income, and specific prohibition of certain deductions. Not all of the sections which set forth these methods bear directly on housing, of course, but some do have influence even though nothing is said about housing in their text. Legislative history sometimes fails to clarify these sections because they were enacted long ago without any effort to effect a consistent federal tax policy toward housing questions.

Unlike tax provisions which are applicable only to a limited number of persons, those sections dealing with housing are of universal effect. Over 10 per cent of consumer expenditures are made for housing,[1] which makes it a major item in the cost of living. Any distinction in the tax law between various forms of housing expenditures is bound to have significance in determining the relative tax burdens of individuals.

For purposes of discussion, the costs of providing housing will be divided into several classifications: interest on borrowed money, a fair return on capital invested by the owner, real estate taxes, insurance against casualty losses, and all other expenses. It should be noted that these costs must be paid regardless of what form of housing is used. The individual can bear expenses directly; he can reimburse a landlord; or he can be subsidized. It will be contended that current tax policies toward various methods of paying for housing make distinctions which result in an unfair apportionment of the tax burden.

Imputed Income

The benefit received by an individual through the use of his own real estate is called imputed rent. "The amount of imputed rent is considered equal to the amount obtainable if the property were rented to others." Imputed rent is only one form of imputed income, but it is one of the most significant when measured in monetary terms.[2]

* The author is an attorney in Rock Island, Illinois.

[1] U. S. Department of Commerce, Bureau of the Census, *Statistical Abstract of the United States: 1956*, p. 303.

[2] Marsh, "The Taxation of Imputed Income," *Political Science Quarterly*, Vol. 58 (1943), pp. 514, 523.

Because imputed income is not taxed, there is an immense tax benefit to the person who occupies his own home.[3] An individual with a given sum of money to invest has the choice of purchasing a home or investing in income-producing activities and using the cash to pay rent. If there were no tax considerations, the cash received from the investments would pay the rent on a residence substantially equal to one that could be purchased by making the same investment in a home. The bias in favor of home owners arises because the imputed income from the investment in the home would not be taxed, while the cash from an ordinary income-producing investment would be taxed.[4] Because of this tax differential, it takes a greater economic sacrifice to obtain rental quarters than it does to obtain the use of a home through outright ownership.

The exclusion of imputed income from the tax base gives the tax a regressive effect. The tax benefits of home ownership accrue mainly to the upper brackets[5] because of the tendency for home ownership to increase directly with income.[6] If home ownership is thought to be beneficial it would be more sensible to make it easier at the lower, rather than the higher, end of the economic scale.

> However desirable home ownership may be as a social institution, the omission of this imputed net rent from the present federal income tax base is hardly the most appropriate or the most effective method of promoting home ownership. Even if a subsidy of home ownership should be considered proper, this particular form is inefficient, for the subsidy is greatest at the top of the income scale where the need for such a stimulus is least.[7]

It would be much more fair to have the discrimination between renters and home-owners removed from the income tax. If Congress then wished to influence housing habits it could do so by appropriations whose purposes could be publicized and controlled.

The bias caused by the present tax inequality between renters and home-owners, while objectionable on policy grounds, probably cannot be attacked successfully through judicial intervention. In *Brushaber v. Union Pacific R.R.*,[8] which upheld the constitutionality of the 1913 income tax, the plaintiff stated in his complaint:

> The provisions of the . . . Act . . . permit . . . [an] owner to exclude such estimated rental of his home as income. Such a result gives a benefit . . . to one who owns his home over one who rents it . . . while the renter of a house has no . . . exemption, as he is obliged to pay a tax on so much of his income as he expends in rent. If the renter cannot deduct as an expense what he pays as rent, the owner, who has no such expense, should be charged with the rental value of his home . . .[9]

[3] The portion of imputed rent applicable to a fair return on capital invested, real estate taxes deducted under § 164, and mortgage interest deducted under § 163 is tax-free income to the home-owner. Those elements of imputed rent which represent various non-deductible expenses as repairs, insurance, and depreciation have no special tax significance since they must be paid from take-home pay by both home-owners and renters.

[4] § 61(a)(4), (5), (7).

[5] Paul, "Erosion of the Tax Base and Rate Structure," *Tax Law Review*, Vol. 11 (1956), pp. 203, 214.

[6] In 1957, for example, about 40 per cent of non-farm spending units with incomes of less than $4,000 owned their own homes, in contrast to 83 per cent in the $10,000 and over income class. "1957 Survey—Housing and Durable Goods," *Federal Reserve Bulletin*, June, 1957, p. 639.

[7] Vickrey, *Agenda for Progressive Taxation* (1947), p. 18.

[8] 240 U.S. 1 (1916).

[9] Transcript of Record, p. 21, Brushaber v. Union Pacific R.R., 240 U.S. 1 (1916).

The court recognized this as one of the issues in the case; but it termed this and other arguments " minute " and " hypercritical," and went on to hold that the requirement of uniformity in taxation " exacts only a geographical uniformity." [10]

It is clear that since the *Brushaber* case there can be no serious constitutional objection to the *ex*clusion of imputed income on homes from taxable income, but the question remains as to the constitutionality of its *in*clusion. The answer is not entirely clear because there has been a legislative policy to exempt such income so the constitutional question is never reached. In the early income taxes, the tendency was to have either no reference to the problem,[11] or to specifically exclude imputed income from taxable income.[12] Since the Civil War the policy has been to omit any reference to imputed income as in the 1870 tax [13] and the 1894 tax.[14] This omission was continued in the first of the modern income taxes [15] and carries through to the present Code.

There has been no enactment or serious American [16] federal legislative proposal attempting to tax imputed income, and in recent years there has not been even a statutory disclaimer of such taxes. The American Law Institute thought of the problem during the drafting of the 1954 Code, but decided to endorse continuance of the policy of omission by saying:

> Consideration has been given to a specific exclusion of imputed income in the following tentative form:
>
> *Imputed Income.*—Amounts in the nature of imputed income, including the rental value of an owner-occupied residence, . . .
>
> However, it is believed that this exclusion, while generally representing present law, might through the implications therefrom shape the content of " income " . . . in a manner that would cause considerable difficulty in view of the absence of judicial and administrative exploration in this area.[17]

The closest that any federal tax statute has come to taxing imputed income from the occupation of real estate by the owner was a provision relating to insurance companies enacted in 1921 which provided that:

> No deduction shall be made [for expenses attributable to real estate] . . . on account of any real estate owned and occupied in whole or in part by a life insurance company unless there is included in the return of gross income the rental value of the space so occupied . . .[18]

The constitutionality of this provision was upheld in *Helvering v. Independent Life Ins. Co.*[19] By relying upon the theory that Congress has the power to limit or condition deductions, the Court

[10] 240 U.S. at 23 and 24.

[11] Act of 1861, § 49, 12 Stat. 309.

[12] Act of 1864, § 117, as amended, 14 Stat. 478 (1867), which provided that " there shall be included all income . . . except the rental value of any homestead used or occupied by any person or by his family in his own right or in the right of his wife . . . . "

[13] Act of 1870, § 9, 16 Stat. 258 (imputed income not mentioned).

[14] Act of 1894, § 28, 28 Stat. 553 (imputed income not mentioned). This law was declared unconstitutional in Pollock v. Farmers' Loan & Trust Co., 157 U.S. 429 (1895).

[15] Revenue Act of 1913, § II.B., 38 Stat. 167 (imputed income not mentioned).

[16] The English law taxes imputed rents. The Income Tax Act, 1952, 15 & 16 Geo. 6 & 1 Eliz. 2, c. 10, § 222 provides that " [If a taxpayer] . . . is both owner and occupier . . . of lands . . . the amount of the annual value . . . shall be deemed to be income . . . . "

[17] American Law Institute, *Federal Income Tax Statute* (Feb. 1954 Draft), p. 207.

[18] Revenue Act of 1921, § 245 (b), 42 Stat. 262.

[19] 292 U.S. 371 (1934).

was able to find that the imputed rent was not really being taxed at all, but was included merely for the purpose of avoiding a complicated apportionment of expenses between those portions of the building operated for an investment and those portions occupied by the company. It was clear to the Court that the purpose of the law was to tax only the net investment income of the company.

The dicta in the *Independent* case as to what would be the result if the statute had in fact taxed imputed income throws constitutional doubts on the power of Congress to tax such income.

> If the statute lays taxes on the part of the building occupied by the owner or upon the rental value of that space, it cannot be sustained, for that would be to lay a direct tax requiring apportionment. [citations omitted]. The rental value of the building used by the owner does not constitute income within the meaning of the Sixteenth Amendment . . .[20]

It has been asked whether these statements actually state the present-day constitutional limitations. While the opinion has been expressed that there are no constitutional problems,[21] it should be noted that the *Independent* case has been cited several times as authority for various points by the Supreme Court, and many times by other courts, and has never been questioned.

As long as imputed income is not taxed, individuals are well advised to secure the benefits of this omission by purchasing their homes. Of course, many persons cannot do this because of lack of capital, uncertainty as to the type of housing needed in the near future, or anticipated changes in location. However, if an individual is settled in his style of quarters and geographical location, and if he has some capital, then it may be stated that he can reap a tax benefit by purchasing personal housing rather than acquiring income-producing securities.

Non-business Deductions

While it is interesting to speculate on the power of Congress to tax gross income,[22] it has always been the legislative policy to levy the income tax against a net figure arrived at after certain deductions have been taken. The Code permits in broad language the deduction of business expenses,[23] and specifically disallows the deduction of any " personal, living, or family expenses," unless " otherwise expressly provided." [24] Congress has " otherwise expressly provided " for certain deductions which, in the absence of special legislation, would clearly be non-deductible personal expenses.[25] Because personal housing is not usually considered a business expense, the non-business deductions must be especially scrutinized.

To the extent that the cost of housing can be brought under the heading of one of the non-business deductions the government suffers a significant loss of revenue,[26] and to the extent that reve-

[20] *Id.* at 378.

[21] Pechman, " Erosion of the Individual Income Tax," *National Tax Journal*, March, 1957, p. 14 n.

[22] See note, " Taxability of Gross Income Under the Sixteenth Amendment," *Columbia Law Review*, Vol. 36 (1936), p. 274.

[23] § 62(1), (2).

[24] §§ 261-262.

[25] In the case of individuals, the deductions permitted by § 163 (interest), § 164 (taxes), § 165 (losses), and § 166 (bad debts) sometimes could be apportioned between business and personal purposes; but the deductions authorized by § 170 (charitable contributions), § 213 (medical expense), § 214 (care of dependents), § 215 (alimony), and § 216 (cooperative housing) are clearly personal expenses.

[26] Paul, note 12 *supra*, lists this as one of the nine major leakages in the Code (p. 210).

nue is lost there is a subsidy to the taxpayer taking the deduction. This would not be objectionable if the benefit were available to all upon equal terms, but as a practical matter persons occupying their own dwellings gain a substantial advantage.

The deduction for local real estate taxes [27] is one of the largest of the non-business deductions in terms of dollar amount taken.[28] This deduction has been in the tax law from the very earliest acts,[29] and apparently there has been little concern over its impact on housing. The old problem of whether the federal income tax itself was a deductible item was finally settled in 1917 in favor of no deduction, but not until after some debate.[30] There was also some difficulty over apportionment of accrued local taxes between buyer and seller of real estate which is now settled by statute,[31] but the direct effects of this deduction on housing costs never have been placed clearly in issue.

It is clear that the deduction for local real estate taxes places an undue burden on tenants.[32] In this connection it should be noted that local real estate taxes directly influence the rent that the tenant must pay, and the landlord can be thought of as a collecting agency for the local government. Local real estate taxes are a cost of providing housing, whether rented or owned, and it is unfair for one segment of the public to be able to deduct what is essentially a personal expense while others must meet this cost out of take-home pay.

Individual home-owners who are in a position to influence the real estate tax rate in their local communities might give some consideration to the relationship of their local and federal taxes. Through expansion of local services it is possible to convert what would ordinarily be non-deductible personal expenses into deductions.[33] The resulting increase in local taxes would be partly offset by a decrease in federal income taxes, and the federal government would be forced to absorb part of the expense.[34] While the use of local taxing power to finance services which could be provided by personal effort is not usually a sound policy, it might be less expensive for the individual, especially in a community of home-owners.

The deduction for interest [35] is another important non-business deduction which bears on housing costs.[36] Because of the popular custom of purchasing homes with borrowed funds, interest is

27 § 164.

28 Chart III, below, shows as taxes all deductible taxes whether local real estate or otherwise. Against this can be balanced the fact that the deductions for taxes on cooperative housing are included in the miscellaneous category.

29 Act of 1861, § 49, 12 Stat. 309.

30 Various early acts were not too clear, *ibid.* (apparently deductible); Act of 1864, § 117, 13 Stat. 281 (not deductible); Revenue Act of 1913, § II.B., 38 Stat. 167 (apparently deductible). The question was settled in Revenue Act of 1917, § 1201(1)Third, 40 Stat. 330 (now § 164(b)(1)). For the debate at the time, see 55 Cong. Rec. 6317-6326 (1917).

31 § 164(d).

32 Vickrey, *op. cit.*, note 7.

33 As an example, assume a residential community where the water supply is operated as a private business. The water bills would be non-deductible as a personal expense under § 262; but if the water were supplied by the local government at less than cost, or even "free," the resulting increase in taxes would be deductible under § 164. Even though the municipal system might be less efficient than a private enterprise, the individual consumer might be better off if the cost were paid indirectly as a tax rather than directly as a water bill.

34 The reverse of this is considered in Evans, "The Relation of Federal and State Taxation," *Tennessee Law Review*, Vol. 21 (1951), pp. 829, 836, where it is argued that a deduction for the federal tax on state returns has resulted in a decrease in state revenue because of increases in the federal tax.

35 § 163.

36 Chart III, below.

one of the major costs of providing housing, and the fact that the interest is a personal expense does not prevent its being deducted.[37] Again it should be noted that a tenant must pay this cost in the form of increased rent to his landlord, although the tenant gets no deduction. The effect of the interest deduction on the relative positions of renters and mortgagors was argued in the debates on the 1913 Act, but the deduction was retained over the express objection that it discriminated against renters.[38]

In comparing the polar positions of renters with persons owning their homes free of mortgages it is clear that a mortgagor falls between. An interest deduction has the effect of moving the mortgagor closer to the outright owner and further from the tenant. The present Code permits the deduction of interest and places the mortgagor substantially ahead of the renter, as shown in Table I. Any movement to abolish the interest deduction would have to deal with the opposition of mortgagors who would fight to retain their advantageous position.

The legislative history of the interest deduction offers little insight into the reasons for its existence. It can be surmised that one reason is a vague feeling of sympathy for struggling borrowers. A colorful picture of a helpless debtor harassed by a loan shark can be visualized; but in the present atmosphere of "tight money," record consumer debt, and competition among prospective borrowers for available funds, the wisdom of granting a tax subsidy to borrowers is questionable.

"An alternative explanation [for the interest deduction] is that it is difficult to draw the line between the purposes of personal loans and business loans of single proprietors and partners.[39] Actually, this is a problem that exists under the present Code because an individual proprietor sometimes must allocate his interest expense between business expenses under section 62(1) and personal interest under section 163. There is an incentive in some cases to classify as much of the interest as possible as a business expense because an individual using the standard deduction cannot deduct personal interest,[40] and an individual itemizing deductions will usually want to have a low adjusted gross income.[41] This problem would become serious if personal interest were disallowed, but could be solved by limiting the amount of business debts to the basis of the taxpayer's investment in the business.[42] This plan would give an interest deduction to the home-owner who mortgages his home to raise funds for business purposes, but would permit the

[37] In Preston v. Comm'r, 132 F.2d 763 (2d Cir. 1942), the court expressly rejected (at 766) the Commissioner's argument that the interest deduction should be restricted to the expense of borrowing money for income-producing purposes, and a deduction for interest on money borrowed to make a gift was allowed.

[38] "Here is one man, for example, who has purchased a home. He has given a mortgage upon it for its price . . . and is paying . . . interest. Under this bill that would be deducted . . . . But if his neighbor has rented a house, and instead of virtually paying what the first-named man does in the form of interest he pays . . . rent. He gets no deduction whatever, and yet the situation of the two is to all intents and purposes precisely the same . . . ." [Argument by Senator Sutherland of Utah] 50 Cong. Rec. 3848 (1913).

[39] Pechman, note 21, above.

[40] § 63(b).

[41] A low adjusted gross income would increase the amount of deductible medical expense. § 213(a). *Contra*, it would decrease the maximum permissible charitable deduction. § 170(b)(1).

[42] This proposal assumes that the interest deduction now in § 163 has been limited to interest on business indebtedness.

general repeal of the deduction for personal interest.

Related to the question of interest and tax deductions is the deduction for "amounts representing taxes and interest paid to cooperative housing corporation." [43] Prior to the enactment of this provision, the occupants of cooperative housing were in the tax position of tenants, and the portion of their rent which was used for interest and taxes was not deductible.[44] The present Code permits the interest and taxes paid by the cooperative to be deducted by the occupant and results in giving him the tax status of a home-owner.

The cooperative housing deduction was placed in the law for the express purpose of giving the advantages of the home-owning class to the occupants of cooperatives.[45] At a time of surplus revenue and a tendency to reduce taxes, a deduction for cooperative occupants was proposed in the 1928 House bill,[46] but was rejected by the Senate because, among other things, "it is not given to the great number of individuals who lease apartments . . ." [47] Oddly enough, in 1942, a year when taxes were being raised and revenue needs were at a record high, the deduction was enacted.[48] This time the Senate used practically the identical language of the 1928 House Report by saying:

> The bill provides for a new deduction . . . of taxes and interest paid or accrued by a tenant stockholder to a cooperative apartment corporation. . . . The general purpose of this provision is to place the tenant stockholders of a cooperative apartment in the same position as the owner of a dwelling house so far as the deductions for interest and taxes are concerned.[49]

Once it is accepted that owners are to bear less of the tax load than renters, it seems reasonable that cooperative apartment dwellers should be in the owner class rather than the renter class. The existence of this hybrid group, however, points up the fact that all persons must pay interest and taxes in the cost of their housing whether or not they are deductible.

One of the costs of housing is the risk that the particular housing facility may be damaged or lost through some unavoidable casualty. This risk can be covered by insurance or carried by the individual as a self-insurer; but regardless of the form of coverage or ownership, the risk is there and must be paid for. This cost would have no tax effect if it were not for the fact that casualty losses are deductible, even on non-business property.[50] Through this deduction the government bears a portion of the damage caused by various disasters.[51]

The need for this deduction to alleviate the hardship of these losses was recognized early [52] and carries through to the

[43] § 216.

[44] Wood v. Rasquin, 21 F. Supp. 211 (E.D.N.Y. 1937). On peculiar facts, however, a deduction for taxes paid to a cooperative was allowed in Borland v. Comm'r, 123 F.2d 358 (7th Cir. 1941), although there was no statutory authority for such a deduction at that time.

[45] S. Rep. No. 1631, 77th Cong., 2d Sess. 51 (1942).

[46] H.R. Rep. No. 2, 70th Cong., 1st Sess. 14 (1928).

[47] S. Rep. No. 960, 70th Cong., 1st Sess. 20 (1928).

[48] Int. Rev. Code of 1939, § 23(z), added by 56 Stat. 826 (1942).

[49] *Op. cit.*, note 45.

[50] § 165(c)(3).

[51] It has been estimated that the damage done by the 1954 hurricanes will cost the government $400 million in lost revenue. Felt, "Tax Effects of Hurricane Losses," *Taxes*, Vol. 33 (1955), p. 327.

[52] The deduction for non-business casualty losses originated from this suggestion by Congressman Wilson of Iowa:

"Last year it was held by the Commissioner that

(See next page)

present Code. In actual application, however, an inequity has developed in the treatment of insured losses. Since 1894, losses covered by insurance have not been deductible, so that the benefits of this deduction have been limited.[53] It is arguable that the exclusion of insured losses, while allowing the deduction of uninsured losses, has made the government a partial unnamed beneficiary of insurance policies on personal residences, at least to the extent that the owner pays income tax. Because of the exclusion of insured losses, it is advisable for a taxpayer to self-insure as much as possible.[54] Persons with limited resources, however, cannot afford to take risks, so they must insure and lose the benefit of the deduction.

The policy behind the casualty loss deduction would still be served even if the premiums on insurance against these losses were deductible.[55] An addition to the statute would be necessary, but the change would make the cost of the insurance comparable to the benefit received regardless of the size of the taxpayer's income. Also, to be fair and consistent, the residents of cooperatives should have the costs of casualty insurance imputed to them. Casualty losses are not presently imputed to cooperative residents.

In measuring the effects of the deductions for taxes, interest, and casualty losses,[56] the standard deduction must also be considered. The standard deduction was placed in the law for the purposes of reducing computations and simplifying the forms.[57] Because of the necessity of computing the tax both with and without the standard deduction in many cases,[58] it is questionable whether the goal of reducing the number of calculations has been achieved; but there is no doubt that administration is easier with a standard deduction.

While the immediate effect of the adoption of the standard deduction was to grant some tax relief to those taxpayers having deductions amounting, to less than standard, the long range effect was just the opposite. The benefit of itemized deductions is now largely lost to the lower brackets because these taxpayers usually use the standard deduction as shown in Charts I and II. Itemized deductions naturally benefit only those who itemize, although often their ostensible purpose is to assist all persons paying such expenses.[59]

no loss should be deducted from the income which was not incurred in some business out of which the party derived a profit, and where the loss incurred overbalanced the amount of profit. Now, I propose to extend that so that all losses from the causes mentioned, either by fire or shipwreck, or incurred in trade, shall be deducted from the income." Cong. Globe, 39th Cong., 1st Sess. 2787 (1866).

See Act of 1864, § 117, as amended, 14 Stat. 478 (1867).

53 Chart No. III.

54 A self-insurance plan would cost only a fraction of the commercial insurance premium. In addition to the income tax benefits, the administrative expenses of the insurance company would be avoided. In the case of an individual who could not take the full risk as a self-insurer, these advantages could be partially attained by having the insurance policies cover only the losses over a stated amount.

55 *Cf.* The medical deduction recognizes that insurance against medical expenses is a medical expense itself. § 213 (e) (1) (A).

56 When the taxpayer has long-term capital gains, casualty losses sometimes may be offset against the gains even though the standard deduction is elected. § 1231 (a) (2). U. S. Internal Revenue Service, Treasury Department, Pub. No. 155, *How the Federal Income Tax Applies to Losses from Hurricanes, Floods, and Other Disasters* (1955), p. 5.

57 Int. Rev. Code of 1939, § 23 (aa), added by 58 Stat. 236 (1944). S. Rep. No. 885, 78th Cong., 2d Sess. 1 (1944); H.R. Rep. No. 1365, 78th Cong., 2d Sess. 1 (1944).

58 See Koch, "How Standard Is the Standard Deduction on Short-Form 1040?," *Taxes*, Vol. 29 (1951), p. 367.

59 The new child care deduction in § 214 (b) (2) (B), for example, limits its benefits in certain cases where income exceeds $4,500. Compare Chart II. Of the

(See next page)

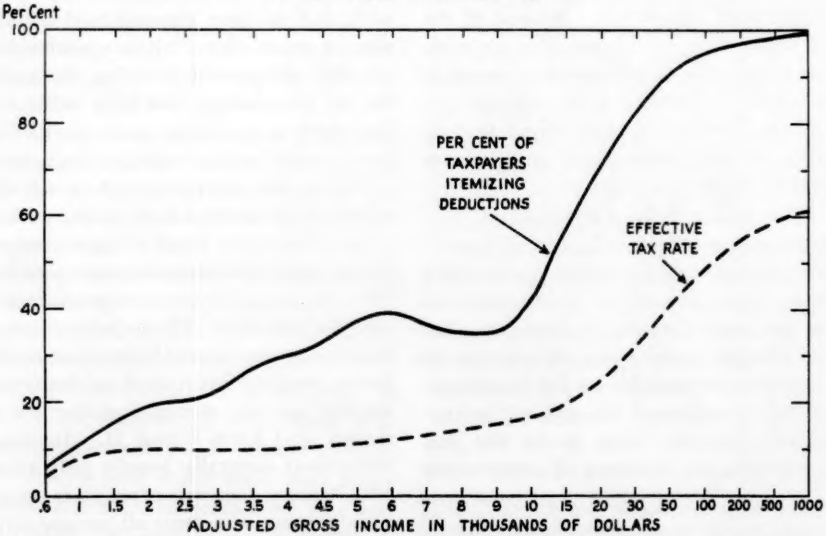
In addition to the direct benefit from the deductions for taxes and interest, home owners also derive an indirect benefit by being able to utilize other itemized deductions. Other taxpayers, particularly those in the lower and middle income brackets who rent their living quarters, can rarely accumulate deductions aggregating more than the standard deduction. The result is that home owners are the primary beneficiaries of the remaining deductions . . .[60]

When the use of the various deductions is compared to the amount of income, it can be seen that the importance of the interest and tax deductions generally increases with increasing income (Chart III). The few taxpayers in the lower income groups who are able to itemize use, primarily, the medical and charitable deductions (Chart II). As a result, the deductions arising from ownership of a home are often crucial in obtaining benefit from itemized deductions. A serious medical emergency in a lower-bracket family often affords no tax relief, while the identical situation in an upper-bracket home-owning family would result in governmental assistance through lower taxes.

This unfortunate, and probably unintended, effect of the standard deduction

CHART I

A Comparison of the Use of the Standard Deduction With Effective Tax Rates at Various Levels of Income



Source: Internal Revenue Service, *Statistics of Income for 1953*, Pt. 1.

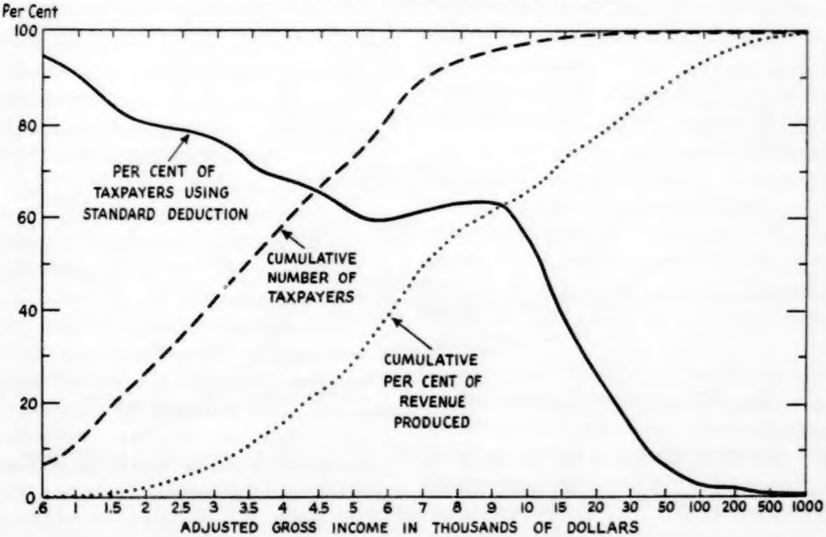
returns reporting an income of $4,500, about two-thirds use the standard deduction; and returns reporting smaller incomes use the standard deduction to an even greater degree. Those using the standard deduction get no benefit from the child care deduction even though all the requirements of the child care section itself are satisfied. § 63 (b).

60 Pechman, *art. cit.*, p. 6.

should be corrected even if nothing else is done to bring about equity between home-owners and renters. The basic philosophy of the standard deduction could be retained, but its application should be based on each itemized deduction rather than the total of all itemized deductions. Each deduction section could provide that only the excess over the present medical deduction,[62] and the present over-all standard deduction could be eliminated.[63] The percentage "floors" would be set high enough in each case to eliminate deductions for normal living costs, to attain the goal of simplification, and to prevent loss of revenue. Under this proposal, a taxpayer who had unusually high expenses

CHART II

THE EFFECT OF THE LEVEL OF INCOME ON THE USE OF THE STANDARD DEDUCTION, NUMBER OF TAXPAYERS, AND REVENUE PRODUCED



Source: Internal Revenue Service, *Statistics of Income for 1953*, Pt. 1.

a stated percentage of adjusted gross income would be deductible,[61] much like

[61] The percentage limitation should be applied only to individuals claiming deductions for interest (§ 163), taxes (§ 164), losses (§ 165), and bad debts (§ 166) to the extent that these deduction are taken for non-business purposes, and to contributions (§ 170) and medical expenses (§ 213).

The deductions for child care (§ 214) and alimony (§ 215) could be continued without any new limitations since the purpose of these deductions is to grant relief to certain narrowly defined groups in amounts already limited by exact standards. The other itemized deductions listed in §§ 161-217 are in the nature of trade or business expenses and need no new limitations.

[62] The medical deduction in § 213 applies, with certain exceptions, only to the extent that the expenses exceed 3% of adjusted gross income. Under present law, no medical expenses can be deducted if the standard deduction is used. § 63(b). If the over-all standard deduction were eliminated, as has been proposed, the percentage limitation of the medical deduction would have to be increased in the interests of efficient administration and preservation of revenue.

[63] §§ 141-145.

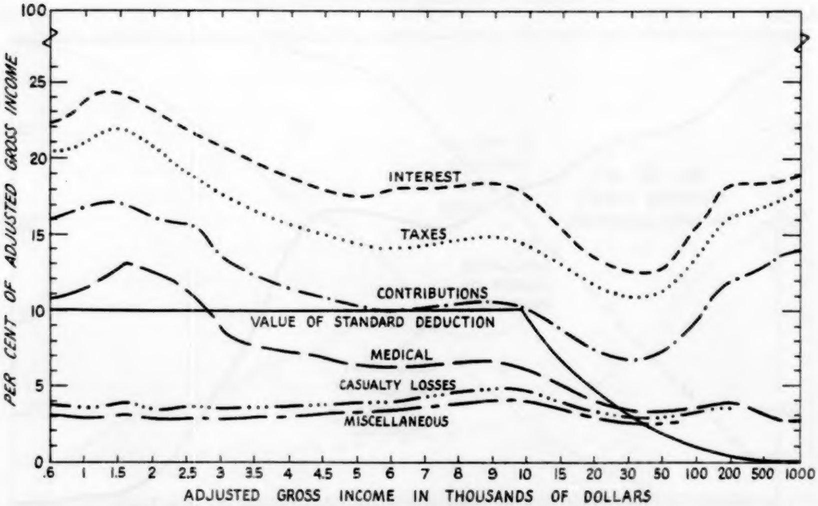
of a certain type (medical expenses for example) would be able to deduct that particular expense even though other expenses were not large enough to itemize.

One method of ending the discrimination between home-owners and renters that has been proposed is to bring imputed income within the scope of taxable income and to eliminate the deductions for taxes and interest.[64] While this proposal would undoubtedly solve the problem, it should be recognized that as a matter of practical politics it will be impossible to take away a tax benefit vested in 60 per cent of the population.[65] On the other hand, a limited deduction for rent could achieve the same degree of equity and would be feasible politically.[66]

Several of the early income tax laws included a deduction for rent paid for use of a personal residence, but the modern tendency has been to prohibit the deduction of living expenses.[67] This

CHART III

THE RELATIVE AMOUNTS OF ITEMIZED DEDUCTIONS AT VARIOUS LEVELS OF INCOME



= Value of Standard Deduction

Source: U. S. Internal Revenue Service, *Statistics of Income for 1953*, Pt. 1.

[64] Pechman, *art. cit.*, p. 14.

[65] In 1956 about 40 per cent of the dwelling units in the United States were rented and 60 per cent owned by the occupant; in 1950 about 45 per cent were rented and 55 per cent owned. *1956 Statistical Abstract*, p. 775.

[66] Marsh, *art. cit.*, p. 533.

[67] "[In determining taxable] . . . income . . . the amount actually paid . . . for the rent of the dwelling house or estate on which [the taxpayer] . . . resides shall be first deducted from . . . income . . . ."

Act of 1862, § 91, as amended, 12 Stat. 723 (1863).

"[There shall be allowed as a deduction] . . . the amount actually paid by any person for the rent of the house or premises occupied as a residence for himself or his family . . . ." Act of 1864, § 117, as amended, 14 Stat. 478 (1867).

A similar deduction was allowed in the Act of 1870, § 9, 16 Stat. 258. The Act of 1894, § 28, 28

(See next page)

can probably be explained by the rising percentage of home-owners over the years. Reinstatement of this deduction into the law would be favored by the tenant class and probably would be opposed by the comparatively few people who are interested in keeping the tax base broad. The answer to these objectors would be that the only practical way to end this particular discrimination is to give it to all; once this is done, it will become politically possible to eliminate all the deductions and bring down the rates. This proposed deduction for rent would be simple to administer and also would avoid the necessity of determining the fair rental value of every owner-occupied home.

An unlimited deduction for rent would not be fair because rent usually includes some costs that would not be deductible directly. The portion of the rent that should be deductible is that part which represents interest, local real estate taxes, and a fair return on the capital invested, which are now deducted or excluded by home-owners. The rent payments applicable to such costs as heat, light, water, repairs, depreciation, and use of furniture are not now deductible by anyone and should continue to be non-deductible.

To avoid the administrative task of apportioning rent payments between the deductible and non-deductible costs, a rent deduction should be limited to a certain percentage of adjusted gross income. The percentage could be computed on the basis of what general experience shows to be the ratio of the tax-free elements of rent to adjusted gross income. To prevent abuse of this deduction by very wealthy persons, it could be limited further by a specific dollar ceiling. Although a rent deduction with these limitations could not be perfect in all cases,[68] it would achieve substantial equity, and would be a great improvement over the present method. It would also have the advantage of being beyond constitutional attack.[69]

Miscellaneous Provisions

There are several provisions in the Code which have been enacted to eliminate the tax on the housing costs of certain individuals. The section dealing with "meals or lodging furnished for the convenience of the employer"[70] is new to the Code and potentially could be used by many employees. Employers who can utilize this section can increase their employees' real income at the expense of the government. "Perhaps by reason of taxes our society is moving back to the status of a barter economy."[71]

The past history of employer-furnished housing was one of great uncertainty as to whether a given situation resulted in taxable income to the employee, and section 119 was inserted "to end the confusion."[72] Whether section 119 has caused more uncertainty than it has cured is a debatable point.[73] The crucial test under this section is whether "the employee is required to accept such

Stat. 553, was silent on the subject; but beginning with the Revenue Act of 1913, § II.B. First, 38 Stat. 167, all laws have had the provision specifically prohibiting deductions for living expenses now found in § 262.

[68] The fact that some states utilize real estate taxes to a greater degree than others would cause some discrepancy.

[69] *Accord*, Florida v. Mellon, 273 U.S. 12 (1927).

[70] § 119.

[71] Cary, "Pressure Groups and the Revenue Code," *Harvard Law Review*, Vol. 68 (1955), pp. 745, 771.

[72] See note, *Michigan Law Review*, Vol. 53 (1955), p. 871; also S. Rep. No. 1622, 83d Cong., 2d Sess. 19 (1954).

[73] See Erbacher, "Meals or Lodging Furnished for Convenience of Employer," *Taxes*, Vol. 32 (1954), p. 826.

lodging on the business premises of his employer as a condition of his employment," [74] but this definition is subject to difficulties in interpretation when applied to specific cases. If housing were frankly excluded from the tax base of everyone, as it now is for some taxpayers, then these problems of interpretation would be eliminated. Any employee living in quarters furnished by the employer would receive his housing tax-free just like everyone else.

The housing costs of ministers of religion have received special tax treatment since 1921.[75] The original provision permitted a minister who was furnished a home by the church to exclude the rental value of the home from taxable income, and the 1954 Code extended this relief to ministers who rented their homes with the proceeds of cash housing allowances.[76] These provisions have been interpreted to give a minister who already owns his own home the benefits of both home-ownership and a tax-free housing allowance,[77] as well as tax-free allowances for utilities.[78] This section with its interpretations gives ministers substantial tax relief (Table I).

The provision for ministers has a considerable emotional appeal, but it cannot be justified economically. No explanation was included in either the reports or the debates on the original adoption. Presumably, it can be argued that many ministers are paid low salaries; but it is the progressive rate structure that is supposed to adjust for varying levels of income. It should also be noted that this provision benefits those ministers who are highly paid; yet there is no provision in the Code for the relief of low-paid individuals who are not ministers whose work is also a community service.

Prior to 1951, a gain on the sale of a personal residence was taxed even though the proceeds of the sale were immediately reinvested in another home. The tax on these gains was eliminated [79] with the explanation:

> [The purpose of this bill is] . . . to eliminate a hardship under existing [pre-1951] law which [taxed gains on the sale of a personal residence] . . . The hardship is accentuated when the transactions are necessitated by such facts as an increase in the size of the family or a change in . . . employment. . . . Cases of this type are particularly numerous in periods of rapid change such as mobiliza-

[74] § 119(2); U.S. Treas. Reg. § 1.119-1(b) (1956).

[75] Revenue Act of 1921, § 213(b)(11), 42 Stat. 239.

[76] § 107; H.R. Rep. No. 1337, 83d Cong., 2d Sess. 15 (1954) stated:

"Under the present [pre-1954] law, the rental value of a home furnished a minister of the gospel as part of his salary is not included in his gross income. This is unfair to those ministers who are not furnished a parsonage, but who receive larger salaries (which are taxable) to compensate them for expenses they incur in supplying their own home." [Query: Could this principle be applied fairly to any situation where an employer might have furnished housing to an employee tax-free, but instead chose to pay a cash rental allowance?]

"Your committee has removed the discrimination in existing law by providing that the present exclusion is to apply to rental allowances paid to ministers to the extent used by them to rent or provide a home."

[77] Williamson v. Comm'r, 224 F.2d 377 (8th Cir. 1955), *reversing* 22 T.C. 566 (1954).

[78] Proposed U.S. Treas. Reg. § 1.107(a)(1) (November 15, 1956).

[79] Int. Rev. Code of 1939, § 112(n), added by 65 Stat. 494 (1951) (now § 1034). Residence includes cooperative housing. § 1034(f). It is not quite correct to say that the tax has been eliminated because the gain that is not recognized must be reflected in the basis of the new residence. § 1034(e). When the taxpayer eventually liquidates his investment in personal housing there will be a tax on the gain, but if the taxpayer continues to own a home until death the gain will never be taxed because his heirs will get a basis established by the fair market value at the date of death. § 1014(a).

tion or reconversion. . . .[80]

Undoubtedly this enactment achieves its purpose; however, if flexibility of residence is a desirable social goal it also would be served by placing renting on equal footing with other forms of housing. It would be sensible to make it easy for a shifting, growing family to rent until it is settled in its needs.

TABLE I

INCOME TAX AND FINANCIAL RESULTS OF VARIOUS HOUSING ARRANGEMENTS

Tax Computation	Minister			Other Taxpayer		
	Owner	Mortgagor	Renter	Owner	Mortgagor	Renter
Total cash intake	$6,100	$6,100	$6,100	$6,100	$6,100	$6,100
Less: Tax-free allowance	1,000	1,000	1,000	....	....	....
Adjusted gross income	5,100	5,100	5,100	6,100	6,100	6,100
Less: Taxes on home	150	150	....	150	150	....
Mortgage interest	....	350	....	....	350	....
Other deductions	200	200	....	200	200	....
Standard deduction	....	....	510	....	....	610
Exemptions	3,600	3,600	3,600	3,600	3,600	3,600
Total deductions	3,950	4,300	4,110	3,950	4,300	4,210
Taxable income	1,150	800	990	2,150	1,800	1,890
Federal income tax	$ 230	$ 160	$ 198	$ 430	$ 360	$ 378
Cash Position	Owner	Mortgagor	Renter	Owner	Mortgagor	Renter
Total cash intake	$6,100	$6,100	$6,100	$6,100	$6,100	$6,100
Less: Taxes on home	150	150	....	150	150	....
Mortgage interest	....	350	....	....	350	....
Misc. house exp.	200	200	....	200	200	....
Federal income tax	230	160	198	430	360	378
Rent	....	....	1,600	....	....	1,600
Total expenses	580	860	1,798	780	1,060	1,978
Net cash after paying housing expenses and Federal income tax	$5,520	$5,240	$4,302	$5,320	$5,040	$4,122

Note: Based generally on the facts of Gideon B. Williamson, 22 T.C. 566 (1954), and assumes a hypothetical couple with two children living in a home worth $16,000.

Summary

The present system of individual income taxes places a heavier burden of tax on a renter than on a home-owner in a similar situation. The result is that a renter does not receive as much housing value for a given amount of economic sacrifice as does a home-owner. This might be defensible if everyone had an equal opportunity to become a home-owner, but there are many who, through no fault of their own, are not in a position to own a home.

Some feel that the record of governmental action in the housing field[81] shows neglect of various groups who deserve help. Perhaps these groups need

[80] H.R. Rep. No. 586, 82d Cong., 1st Sess. 27 (1951).

[81] Robinson and Weinstein, "The Federal Government and Housing," *1952 Wisconsin Law Review*, p. 581, reviews the non-tax aspect of Federal housing legislation.

help, but if they do, part of their need is caused by the amount of income tax they must pay. It is inconsistent, to say the least, for the government to declare that private enterprise cannot provide low-rent housing [82] and then proceed to place a discriminatory tax burden on the private funds that would be the source of income for investors in private low-rent projects.

The housing of low-income families has been the object of special governmental concern.[83] Elderly persons, cooperative residents, servicemen, college students and faculty, and persons with moderate incomes are also the subject of special housing legislation.[84] The one generalization that can be made about all of these programs is that their beneficiaries ordinarily tend to be renters. If these renters were not forced to assume such a large proportion of the tax load, perhaps these special housing programs could be reduced or eliminated.

The rapid increase in the number of individually owned homes, partly the result of tax considerations, has accentuated the blight of central rental residential areas. Private investment in rental housing has been discouraged because the rent must be paid out of take-home pay. Additional problems of transportation, schools, and other public facilities are created when the well-to-do are subsidized in the flight to the suburbs while the renters who stay behind are left with the difficulties of urban renewal.

The aids to home-ownership in the income tax law have been of great value to the wealthy taxpayers, but they have been substantially useless to the lower income groups. This has resulted in a shift of the total tax burden toward the lower end of the economic scale, and this shift has frustrated the policy of progressive taxation. The taxes now paid on incomes below $9,000 show very little progression, (Chart I) although this group contains over 95 per cent of the tax-payers and pays over 62 per cent of the income tax (Chart II). Much of this leveling of rates can be ascribed to the increasing numbers of taxpayers who are able to take advantage of the itemized deductions for home-owners. The lack of progression can be corrected, at least partially, by legislation giving equal tax treatment to all forms of housing.

If it is thought to be desirable that certain groups have subsidized housing, then money for this purpose can be appropriated, and through these appropriations the exact legislative purpose can be attained. Either the discriminatory tax benefits accorded presently must be repealed, or the costs of all forms of housing should be recognized openly as having priority over the payment of income taxes. The present system conceals its effects and has created conditions nearly the opposite of what would prevail if the facts were known to all.

[82] 50 Stat. 888 (1937), 42 U.S.C. § 1402(2) (1952).

[83] As of December 31, 1955, there were 567,777 dwelling units owned by the Public Housing Administration of which 489,744 were under the low-rent housing program. *1956 Statistical Abstract*, p. 771.

[84] Respectively: 70 Stat. 1093, 12 U.S.C.A. § 1701h-1 (Supp. 1956); 64 Stat. 54 (1950), 12 U.S.C. § 1715e (1952); §§ 216, 1034(f); 68 Stat. 603 (1954), 12 U.S.C.A. § 1715m (Supp. 1956); 64 Stat. 77 (1950), 12 U.S.C. § 1749 (1952); 62 Stat. 1276 (1948), 12 U.S.C. § 1747 (1952).

THE BURDEN OF THE CORPORATE INCOME TAX REPLY TO MESSRS. RATCHFORD AND HAN

M. A. ADELMAN *

THE very helpful survey article by B. U. Ratchford and P. B. Han [1] may inaugurate an overdue investigation into this important subject. Their views obviously differ from mine.[2] However, the precise areas of disagreement and agreement are not altogether clear to me; and it may be worthwhile to attempt a brief statement and narrowing of issues, without trying to settle the merits.

The idea that the corporate income tax is shifted to consumers or employees rests upon two lines of reasoning. These two are altogether independent; the truth or error of one leaves the other unaffected. One reason involves price behavior under oligopoly. Income taxes may not be shifted under monopoly or competition, but under intermediate conditions, " full-cost " pricing, or inflation, or something else, they can. My view is that only the vagueness of this argument has saved it from the dismissal it merits on both logical and factual grounds.

The other reason is altogether different; in principle, I accepted it myself, so that " unqualified opposition to the view that any shifting is possible " (p. 317) is not accurate paraphrase. Given a lower after-tax profit, I indicated, suppliers of capital or enterprise may supply less, at a higher price, than they would have supplied at the old level. To the extent that they supply less, profits become a *cost*. (Perhaps unwisely, I have not considered the backward-bending supply curve.) Ratchford and Han believe that " this is the crux of the whole problem " (pp. 319-20). I would like to take them literally; their use of the definite article implies that there is no other " crucial " issue than the shape of the supply function—which is exactly what I would urge. But we can do no more than this by *a priori* reasoning. Further progress requires empirical investigation, at which my own article was a first crude attempt. If what Ratchford and Han call the " crucial " hypothesis (which is putting it strongly, but may for purposes of exposition be allowed) is that suppliers of capital-cum-enterprise will put forth less, then it would seem to follow that the income terms of trade, as our brethren in international economics put it, would turn in their favor; hence, within the corporate sphere, their pre-tax incomes would increase more than other claimants'. This has not happened, despite the fact that pre-tax profits are biased *upward* because of a higher rate of utilization of capacity (the higher turnover ratio is an indicator) in the 1946-1956 period as compared to the 1920's.

* The author is Associate Professor of Economics at Massachusetts Institute of Technology.

[1] B. U. Ratchford and P. B. Han, " The Burden of the Corporate Income Tax," *National Tax Journal*, December, 1957, pp. 310-324.

[2] M. A. Adelman, " The Corporate Income Tax in the Long Run," *Journal of Political Economy*, April, 1957, pp. 151-157.

Where do we go from here? Ratchford and Han would emphasize (pp. 320-21) the variations in the impact of the tax upon the respective sectors of the economy. Perhaps, therefore, they would agree to this formulation: the question is whether the shifting of the tax has differed significantly from zero. To answer it, we need some measures of variability; which means an industry-by-industry approach, as sketched in my article. The prediction made there was that this would probably change our whole perspective on the nature of the problem. But lacking the blessing of this knowledge-that-is-to-be, we can only look for evidence that the aggregate supply function, in the range actually traversed, is sharply enough inclined to have some measurable effect, and I cannot discern any.

This, of course, does not justify a prediction that the function may not be much more inclined past the present range. An increase in current tax rates, that is, might have very substantial effects where the previous increases have not. Moreover, the shape and location of the function(s) need not remain fixed.

A COMMENT ON R. S. HOLMES' ARTICLE "OUR FEDERAL INCOME TAX SYSTEM—WHERE DO WE GO FROM HERE?"

HARLEY L. LUTZ *

PROFESSOR Holmes' article, which appeared in the March, 1958 issue of the *National Tax Journal,* argues for elimination of all corporation income taxes and the inclusion of all corporation income, whether distributed or not, in the income of natural persons. This rule of tax liability has always been applied in the case of partnerships, but the Revenue Code of 1954 provided, in Section 1361, that under specified conditions unincorporated business enterprises could elect to be taxed as corporations. For years the law has contained a provision relating to "consent dividends" which permits a corporation to deduct amounts of its income which stockholders have agreed to include in their own returns.

These departures from the ordinary procedure are voluntary. Professor Holmes would require all stockholders to report their pro rata shares of the corporation income. As he says, the idea is not new, but this would indicate that it has a long record of rejection. It is proposed here first, to examine the difficulties and obstacles which the author deals with lightly, although they must have been persuasive against the scheme in the past, else it would stand in higher favor today; and second, to consider the philosophy which underlies his advocacy of this particular cause.

* The author is Professor Emeritus of Public Finance, Princeton University.

Difficulties and obstacles.

The first question to be resolved is—Which particular stockholders, out of the large number of persons who, in the course of a year, may own shares of stock in the public companies, shall be compelled to absorb the corporation income into their own returns and pay the tax at the steeply progressive rates of the individual income tax? Presumably it would be those who owned stock on the "dividend payable dates," for the author says (p. 56):

> The taxpayer would also include in his return both the dividends received on his common stocks and in addition any net income of the corporation not distributed, allocable to the shares held by him.

But why limit the allocation of undistributed income to these particular individuals? In the case of the stocks listed for trading on the exchanges, there are thousands of persons who may be in and out of a given stock without crossing a dividend date as an owner. These operators are seeking short-term capital gains during their period of ownership; and even if they do not receive a cash dividend disbursement, they are, nevertheless, beneficiaries of the corporation's present and prospective earning power in quite as real a sense as those who receive part of the earnings in dividends. True, those whose tenure of stock ownership does not extend to dividend receipt have

no realization of corporation income, but this is equally the case with respect to the undistributed income, so far as dividend recipients are concerned. The author seems unaware of the dangerous implications of the breach his plan would make in the realization rule. This is one of the strongest reasons against favorable consideration of the plan and, by itself, is sufficient to condemn it.

Professor Holmes' answer to the predicament of the person who owns non-dividend-paying stocks would have little appeal for the practical investor. It is that he should switch to dividend-paying or interest-bearing securities to the extent necessary to meet tax obligations. A major objective of investment would thus become the receipt of enough income to pay the tax on realized and imputed income combined. If the dividend paying securities into which the switch were made also had undistributed income, an endless chain of calculation would be involved. It leads to questions about the readiness of many persons to hold stock through a dividend date and the possible market complications resulting from the scramble to let some one else hold the bag, as against a sale for capital gain—or loss—just prior to that date. The matter of allocating losses to stockholders is passed over with a footnote comment that it " raises some interesting problems," a masterpiece of understatement.

If the stockholders who receive the dividends must carry the load of tax on undistributed income, there are seven possible groups that must be identified, namely, the whole-year group, four separate quarterly groups, and two groups receiving two or three dividends, respectively. To reach all of these, the allocation of undistributed income would have to be made on a quarterly basis, according to the income earned but not distributed for the respective quarters. The ensuing complications would be terrific. Many companies maintain a uniform dividend policy through the year and make such additional distribution as the earnings warrant as an extra with the fourth quarter dividend. But that group of stockholders who owned stock only through the first quarter, for example, should, in fairness, have their allocation determined by first quarter earnings. Yet, if at the end of the year much of the income earned but not distributed in earlier quarters is paid out as a year-end extra, then the matter of refunds arises. However, if retained earnings for the whole year are the basis of allocation, then the company would be obliged to go back over its records and identify the separate groups that were owners for one, two, or three dividend payments only, in addition to the whole-year group. The recording and accounting task would be formidable and very expensive, but not insurmountable, if enough manpower were diverted from more useful work to perform it. The Internal Revenue Service would be obliged to increase its staff and add to the number of forms as might be necessary.

The question of legal entity of the corporation is brushed aside as a legalistic fiction, and it is suggested that there is " no valid reason why the government should not pierce the corporate veil if there are good reasons for doing so." We shall see later what the author regards as good reasons. Here it should be noted that a veil that can be pierced can be rent, and eventually torn away entirely. The concept of separate corporate entity evolved over a long period and its superiority over the clumsy part-

nership form of business organization has been fully demonstrated by the immense proportion of all business activity that is now conducted under the corporate form. If this concept can be attacked at one point for one set of "good reasons," it can be attacked at other points for other sets of what other zealous persons could equally well argue were "good reasons."

The Underlying Philosophy.

The evil, or inequity, in the federal tax system which the author seeks to remedy by imputing to, and taxing stockholders on, undistributed corporation income is the variation of tax burden involved in the combination of corporation income tax and progressive individual income tax. The stockholder whose taxable income is within the first taxable income bracket, where the rate is 20 per cent, receives dividend income after it has been taxed to the corporation at 52 per cent; and the stockholder with sufficient income to be subject to the highest progressive rate of 91 per cent, is said to bear only a 52 per cent rate on his allocable share of the corporation income that is not distributed. In consequence, one person is said to be overtaxed, and the other is undertaxed.

The good reason in support of an alternative plan which involves such serious practical and theoretical defects, and such immense administrative difficulties, thus turns out to be the objective of putting each natural person in his proper income rank under the progressive tax on individual incomes. In that ranking Professor Holmes chooses to make use of only one kind of unrealized income, without realizing, apparently, that he is tilting the lid on a Pandora's box of other forms of unrealized income. Unrealized capital gain, for example, and the imputed income value of owner-occupied residences, could easily become fair game, once the veil of realization not only has been pierced but torn away. It is not clear whether the author seeks his objective because of his approval of progressive taxation, or whether he regards it as an institution so firmly established, despite its defects, that adaptation to it must be sought at whatever cost in other directions.

Regardless of the viewpoint, it appears that the case for imputing to stockholders their respective quotas of undistributed corporation income rests on the case for progressive taxation. The problem of equal taxation dealt with in the paper under review would disappear if there were a flat rate of tax on all income, corporate and individual. The credit for dividends paid could then be allowed either to the corporation or to the stockholders, although it would involve less administrative difficulty to allow it to the former. There would no longer be an incentive to "improper" accumulation of surplus earnings, whichever credit method were used. And, as Professors Blum and Kalven point out, a large part of the tax lawyer's problems are either caused or aggravated by the fact of progression.[1]

The present writer has dealt with the defects and fallacies of progression in taxation on various occasions and it is unnecessary to repeat here the arguments advanced elsewhere.[2] These defects have also been discussed by Blum and Kalven in the study cited above.

[1] Walter J. Blum and Harry Kalven, Jr., *The Uneasy Case for Progressive Taxation*, p. 15. University of Chicago Press, 1953.

[2] See, for example, "Federal Tax Policy in the Twentieth Century," in *Proceedings of the Forty-seventh Annual Conference of the National Tax Association*, 1954, pp. 48-56.

The case for progression which these writers analyzed is made still more "uneasy" at this time by developments which put into clear focus this manifestation of national folly.

The reference here is to the issue of maintaining superiority in the long-range economic race against the Soviet Union. At any given time, this superiority may be measurable in terms of satellites, or intercontinental missiles, or bomber divisions, or other phases of military achievement. In the long run it will be determined by relative economic growth. If this growth is to provide a solid foundation of economic and military strength, it must be achieved without inflation. Even assuming that we shall have the understanding and the determination to apply the monetary and nonmonetary policies required to prevent further inflation, it would still be true that vigorous economic growth is dependent on capital formation which, in turn, is dependent on saving and investment. Progressive taxation robs the people of both the capacity to save and the incentive to invest. When our survival depends on economic achievement, how can we be so foolish as to penalize the effort, ingenuity, and energy that alone can make achievement possible?—the effort to work and save, the ingenuity to create new products and devise new machines, and the energy to combine and manage the factors of production toward the goal of greater output.

Blum and Kalven conclude their examination of the case for progression as follows: [3]

> The case has stronger appeal when progressive taxation is viewed as a means of reducing economic inequalities. But the case for economic inequality, when examined directly, is itself perplexing. And the perplexity is greatly magnified for those who in the quest for greater equality are unwilling to argue for radical changes in the fundamental institutions of the society.

It is true that most of the economists and others who support progression are not willing to advocate radical changes in our fundamental institutions. But some other persons do argue for these fundamental changes. These are the socialists and communists. The effects of progression are not dependent upon, nor determined by, the motives of those who believe in its use. Supporters of this doctrine thus unintentionally and unknowingly become collaborators with those who are seeking radical change in our fundamental institutions. Seduction is best accomplished by deception rather than by force. The American people would react violently against any move to overthrow our fundamental institutions by force, but they are being gently led to the same end by a variety of seductive devices, prominent among which is the doctrine of progressive taxation.

[3] *Op. cit.*, p. 104.

BOOK NOTES

Tax Factors in Basing International Business Abroad. By WILLIAM J. GIBBONS. Law School of Harvard University, Cambridge, 1957. Pp. 178. $5.00.

There is no deferral of tax in this country on the foreign income of United States corporations. As a result many of these corporations carry on their foreign operations through holding companies organized in countries that do not tax foreign-source income. The use of this form of organization as a conduit for foreign investment is often described as a " third country " or " tax haven " operation. This book is a study of the laws which govern such operations.

Part I of the book gives the reasons under United States tax laws for using " base companies," companies that will not be taxed on foreign-source income either as holding companies or as trading subsidiaries. It analyzes United States tax laws affecting such operations and points out some of the difficulties in doing business through a " base company."

Part II describes the pertinent tax, corporation, and exchange control laws of thirteen countries selected because they are representative of those which are generally regarded as suitable for the incorporation of base companies. The countries are:

the Bahamas	the Netherlands Antilles
Bermuda	Panama
Canada	Switzerland
Haiti	Tangier
Liberia	Uruguay
Liechtenstein	Venezuela
Luxembourg	

Material on the laws of each country was checked with tax authorities both here and abroad and is intended to present rules and practices in effect as of November 30, 1956.

Sales Taxation. By JOHN F. DUE. The University of Illinois Press, Urbana, 1957. Pp. 396. $5.75.

As its name suggests, this is a comprehensive book. It reexamines all of the principal questions concerning sales taxation: the nature of this form of taxation; the distribution of the burden; the appropriate role of sales taxation in the tax structure, and the different forms and features of sales taxation in light of the experience of various countries.

The sales tax structures of the countries of Britain and Western Europe, Australia and New Zealand, Canada and the states of the United States are described in detail, while those of other countries receive a briefer survey. An examination of the experience of these countries permits the author to emphasize the relative merits of the various types of sales taxation—the turnover tax, the single-stage manufacturers, wholesale, and retail taxes, the value-added tax, and the purchase tax. Attention is also given to various problems common to all forms of sales taxes, such as methods of lessening regressiveness, techniques designed to confine the taxes to consumption goods, and collection procedures.

Municipal Law. By CHARLES S. RHYNE. National Institute of Municipal Law Officers, Washington, D. C., 1957. Pp. 1125. $22.50.

This book is designed to meet the need for a current restatement of the basic principles of law applicable to the modern city. The activities and responsibilities of cities have expanded enormously in the last thirty years, and as a result municipal law has achieved a vastness and complexity not known some years ago. This study attempts to provide the technician in this field with a completely new summary of the law as it exists. It was written pursuant to the instruction and direction of the Executive Committee of the National Institute of Municipal Law Officers.

NTA NOTES

From the President

It was with heavy hearts that the members of the Executive Committee convened in Chicago on April 24. Word had just been received of the untimely passing of our Treasurer E. L. Brickhouse at his home in New York City on April 22. News of the sad event arrived too late to permit cancellation of the meeting because some of the members had already left their homes. Mr. Anthony Quaremba was asked to represent the Executive Committee at the funeral. "Brick," as his friends called him, was a fine gentleman and during his tenure as Treasurer made an outstanding contribution to the Association. He will be greatly missed. At the April meeting Mr. Leo Mattersdorf, now serving as Secretary, was appointed Acting Treasurer for the remainder of Mr. Brickhouse's unexpired term.

The Association is fortunate in that Mrs. Bailey Thull of New York has volunteered to prepare an index of our publications. The last index was prepared many years ago by Roy and Gladys Blakey. A new index will greatly enhance the value of our publications to students and research workers.

At this time, primary interest is centered on the Fifty-first Annual Conference which will be held at the Sheraton Hotel in Philadelphia on October 27-31, but one of the items on the agenda of the April meeting was the selection of the location of the 1960 conference. Hotel reservations for annual conferences must be made two or three years in advance. Selection of places for conferences are made with reference to concentration of membership, other geographical considerations, and hotel accommodations. After careful consideration of several places, the Executive Committee voted to hold the 1960 conference at the Statler Hotel in New York City. The 1959 conference will be held at the Rice Hotel in Houston, Texas.

Mr. Lewis H. Kimmel, Chairman of the Program Committee for the 1958 Conference, reported that plans for the program were progressing satisfactorily. Topics have been selected, and most of the speakers have been engaged. The program promises to be interesting and well diversified. Mr. Theodore K. Warner, Chairman of the Local Arrangements Committee for the 1958 Conference was unable to be present, but he reported by letter that plans for entertainment and other local arrangements were moving forward.

Senator Martin Saxe of New York has been appointed to the special study Committee on Bank Taxation. He has had extensive practical experience in this field and will be able to make a valuable contribution to the work of the Committee. The Executive Committee recommended that a representative of the railroad industry be added to the Federal Excise Taxation Committee. A person has been selected and it is hoped that an announcement can be made of his

acceptance in the near future. Messrs. A. Welles Gray of New York, Vernon A. McGee of Texas, and Edward J. Steimal of Louisiana have been added to the Committee on Financing Public Education. Roger A. Freeman, Chairman, is providing vigorous leadership for this Committee.

Although the Association is nonpolitical, friends of Professor William G. Murray of Iowa will be interested to know that he has won the nomination for Governor of Iowa on the Republican ticket. Professor Murray is Chairman of the Committee on State Equalization of Property Tax Assessments.

Professor Harold M. Groves of Wisconsin, who has long been a fine friend and loyal supporter of the National Tax Association, was recently honored by being elected President of the Mid-West Economics Association.

The Membership Committee under the able leadership of Stanley J. Bowers of Ohio has made an excellent start on this year's membership campaign. Several new corporation and individual memberships have already been secured. Every member is asked to assist in this campaign. Names of persons who ought to belong to our fine organization should be sent to Stanley J. Bowers, State Tax Commissioner, Columbus, Ohio. Personal solicitation by individual members is urged whenever possible. Increased financial resources from increased memberships will enable the Association to expand its special study committees.

The possibility of establishing a new special study committee was discussed at the April meeting of the Executive, but it was decided to defer a definite decision until the July meeting.

At the April meeting the Executive Committee voted to submit to the membership a proposal to increase the size of the Executive Committee from twelve to fifteen elected members. It was the opinion of the Executive Committee that the proposed enlargement would permit better geographical distribution of members and otherwise strengthen the Committee.

Arrangements have been completed whereby Professor E. Cary Brown of the Massachusetts Institute of Technology, beginning with the September issue, will serve for a year as Acting Editor of the *National Tax Journal* while our regular editor, Professor Lawrence E. Thompson is in Europe. We are indeed fortunate in securing such a capable man as Professor Brown to edit the Journal during the absence of our able regular editor. All of us extend to Professor Thompson our best wishes during his European trip.

H. Kenneth Allen, *President*

* * * * *

From the Executive Director

President Allen has magnificently expressed the profound grief of National Tax Association at the untimely passing of Treasurer Brickhouse. Your Executive Director would be restraining his personal feelings if he did not also refer to the most helpful and pleasant relationship which he experienced with " Brick " from the time he assumed the duties of his office.

Recent Study Committee Meetings

Chairman Alfred G. Buehler held a meeting of the Committee on Intergovernmental Fiscal Relations at the Hotel Statler in Washington, D. C. on Thursday, May 15.

Chairman Roger Freeman held a meeting of the Committee on Financing Public Education in the Continental Building, Washington, D. C. on Thursday and Friday, June 26-27.

Both these committees will make important reports at the coming Philadelphia Conference.

Philadelphia Conference

The Sheraton Hotel, headquarters for the 51st Annual Conference, will easily house those who will attend. It is new, modern and most attractive. The management has been most cooperative in making the arrangements and a cordial welcome is assured.

The dates are October 27-31. The registration will start on Monday, October 27. The usual reception will take place late that afternoon. The banquet will be held in the beautiful ballroom Thursday night, October 30. Adjournment will be Friday at noon, October 31. Details will appear in the Preliminary Program which will be sent out sometime before the Conference to all members and delegates.

Reservation cards for hotel rooms, giving selection of rooms and rates, will be mailed each member, together with the Report of the Nominating Committee, at least sixty days prior to the Conference.

Accordingly, all members in all classifications will receive hotel reservation cards and preliminary programs and same need not be requested.

N.A.T.A. Conference

The National Tax Association was well represented at the 26th Annual Meeting of the National Association of Tax Administrators at Coronado, California, June 8-11, 1958. The following members of the N.T.A. Executive Committee were present: Past President J. L. Reuther, Arthur E. Becker, Lawton B. Chandler, William G. Herzel, Vincent D. Kennedy, Otis W. Livingston, Ronald B. Welch and Philip T. Clark. Executive Director Kress also attended. Otis Livingston completed a successful year as President. Martin

Lauterbach of Iowa, another prominent N.T.A. member, was elected President for the coming year. Past President Dixwell L. Pierce was Co-Chairman of the Committee on Local Arrangements. Charles F. Conlon, Executive Secretary of N.A.T.A., whose valuable cooperation with N.T.A. is deeply appreciated, made his usual substantial contribution to the success of the meeting.

Golden Anniversary Proceedings

The Proceedings covering the 1957 Conference will soon be mailed to the members of National Tax Association. The volume is worthy of the 50th Anniversary of this, the oldest, largest and most comprehensive tax organization. Much credit belongs to Chairman Stanley J. Bowers and his Program Committee of last year.

Obituary

The sad news of the passing of Mary Madeline, the wife of Past President Robert S. Ford, on June 13 has just been received. Although Mrs. Ford had not been in good health for some time, her death was sudden and unexpected. The many friends of the Fords in N.T.A. will join in deep sympathy to Bob, one of our most active and most valued members, and his family.

Membership

Vice-President Stanley J. Bowers has his membership campaign in full swing. Some applications resulting from President Allen's work last year, when he was Membership Chairman, have reached the Executive Director's office.

The Membership Roster appearing in the current Proceedings will show those of all classifications belonging to N.T.A. as of July 1, 1958. This information should prove particularly valuable in membership solicitations.

It will be noted that a detachable card has been substituted for the membership application blank which followed the N.T.A. Notes in the last several issues. One side of the card may be used as an *Application for Membership* while the other may serve as a *Recommendation of a Prospective Member.* In case the latter course is chosen, the card should be mailed to Stanley J. Bowers, Vice-President, National Tax Association, 1005 Ohio Depts. Building, Columbus, 15, Ohio.

Increased membership in N.T.A. means

1. More funds for research and study.
2. Even better publications.
3. Even larger conference attendance.
4. A still greater contribution to the tax field.

SO PLEASE USE THE ATTACHED CARD *NOW*

Walter J. Kress, *Executive Director*

NATIONAL TAX ASSOCIATION

Organized 1907—Incorporated 1930

OBJECT. The National Tax Association is a non-political, non-sectarian, and non-profit-making educational organization. Its object, as stated in its certificate of incorporation, is to educate and benefit its members and others by promoting the scientific study of taxation and public finance; by encouraging research; by collecting, preserving, and diffusing scientific information; by organizing conferences; by appointing committees for the investigation of special problems; by formulating and announcing, through the deliberately expressed opinion of its conferences, the best informed thought and ripest administrative experience available; and by promoting better understanding of the common interests of national, state, and local governments in the United States and elsewhere, in matters of taxation and public finance and interstate and international comity in taxation.

MEMBERSHIPS. The Association welcomes to its membership, for mutual discussion and deliberation, all who may be interested in taxation and public finance generally. Annual dues are: memberships for students in recognized institutions of higher learning, \$10; memberships for government agencies, schools, and persons receiving more than one-half of their income from employment by such agencies or schools, \$10; memberships for other individuals and unincorporated entities, \$25; corporate memberships, \$100; persons wishing to contribute more liberally to the support of the Association, \$100 to \$1000.

PUBLICATIONS. The NATIONAL TAX JOURNAL is published quarterly in March, June, September, and December. PROCEEDINGS of the annual conferences on taxation which are sponsored by the Association are published soon after the meetings. The JOURNAL and the PROCEEDINGS are sent to members without charge. To non-members the price of the JOURNAL is \$5.00 per year, single numbers, \$1.50. The prices of the PROCEEDINGS vary; that of the 1956 volume is \$10.50.

Applications for membership, orders for publications, and general inquiries should be addressed to Walter J. Kress, Executive Director, National Tax Association, 905 Payne-Shoemaker Building, Harrisburg, Pennsylvania.